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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-437

MOBIL OIL CORPORATION, *Petitioner*,

v.

FEDERAL POWER COMMISSION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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TABLE OF CONTENTS

	Page
OPINIONS BELOW	1
JURISDICTION	2
QUESTIONS PRESENTED	2
STATUTES INVOLVED	4
STATEMENT	4
1. Proceedings Before the Commission	4
2. Evidence on Rate Structure and the Proposed "Settlement"	6
3. The Commission Opinions	10
4. The Court of Appeals Opinions	15
REASONS FOR GRANTING THE WRIT	20
1. The Questions of Unreasonable, Unduly Discriminatory and Preferential Rate Structure and Treatment of Refunds Are of Nationwide Applicability and Arise Because of Violation of Principles Approved In *Permian* and Conflicts In Constructions of Sections 4 and 5 of the Natural Gas Act by the Courts of Appeals	20
2. The Holdings Below as to Adequacy of Rate Levels Conflict With Requirements of *Permian* and the *Hope* Test and Interject Further Controversies In "Area Rate-making" for Natural Gas Producers	26
3. Provisions For Moratoria Cannot Be Supported By Treatment of Refunds, and Violate This Court's Holding in *Permian* That Moratoria Must Be Supported By Findings As To Future "Stability of Costs" And Revenue Requirements	28
4. Commission Orders As To Mandatory Minimum Charges for Transportation of Liquids and Liquefiable Hydrocarbons Have Been Reversed By the District of Columbia Circuit And Were Erroneously Affirmed Below	30

TABLE OF CONTENTS—Continued

Page

5. The Question of Lawful Allowances For Producers' Payments To Royalty Owners Is Novel Here and Is Applicable To All Regulated Natural Gas Producers' Rates 31

6. In the Face of a Shortage of Natural Gas, the Questions Presented As To Lawful Area Rate Structures Under the Natural Gas Act Are of Critical Importance And Should Be Resolved By This Court 34

CONCLUSION 35

TABLE OF AUTHORITIES

CASES: Page

Burlington Truck Lines, Inc. v. *United States*, 371 U.S. 156 (1962) 29
FPC v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944) 3, 26, 27, 28, 34
Hugoton-Anadarko Area Rate Case: California v. *FPC*, 466 F. 2d 974 (9th Cir. 1972) 24
Interstate Power Co. v. *FPC*, 236 F. 2d 372 (8th Cir. 1956), cert. den., 352 U.S. 967 (1957) 21
Mesa Petroleum Co. v. *FPC*, 441 F. 2d 182 (5th Cir. 1971) 22, 24
Mississippi River Fuel Corp. v. *FPC*, 252 F. 2d 619 (D.C. Cir.), cert. den., 355 U.S. 904 (1957) .. 21
Mobil Oil Corp. v. *FPC*, 463 F. 2d 256 (D.C. Cir. 1971), *cert. den.*, 406 U.S. 976 (1972) 14, 22
Mobil Oil Corp. v. *FPC*, 469 F. 2d 130 (D.C. Cir. 1972), cert. den., 412 U.S. 931 (1973), pet. for reh. pending (No. 72-1108) 6
Mobil Oil Corp. v. *FPC*, —— F. 2d —— (No. 72-1471, D.C. Cir., July 11, 1973) 18, 30
Permian Basin Area Rate Cases, 390 U.S. 747 (1968) ..... 3 and cited throughout
Plaquemines Oil and Gas Co. v. *FPC*, 450 F. 2d 1334 (D.C. Cir. 1971) 22, 24
SEC v. *Chenery Corp.*, 332 U.S. 194 (1947) 29
Southern Louisiana Area Rate Cases (Austral Oil Co. v. *FPC)*, 428 F. 2d 407 (5th Cir.), cert. den., 400 U.S. 950 (1970) 4, 8, 10, 15, 28, 29
Texas Gulf Coast Area Natural Gas Rate Cases (Public Service Commission for the State of New York v. *FPC, et al.)*, —— F. 2d —— (Nos. 71-1828, *et al.*, D.C. Cir., August 24, 1973) 2, 19, 20, 21, 24, 25

ADMINISTRATIVE DECISIONS:

Area Rate Proceedings (Permian Basin Area II), Docket No. AR70-1 (Phase I), —— FPC —— (Opinion No. 662, Aug. 7, 1973) 20

TABLE OF AUTHORITIES—Continued

	Page
Area Rate Proceedings (Other Southwest Area), Docket No. AR67-1, *et al.*, —— FPC —— (Opinion No. 605, Oct. 29, 1971), aff'd. *sub nom. Other Southwest Area Rate Case*, —— F. 2d —— (No. 72-1114, *et al.*, 5th Cir., June 8, 1973)	20
Area Rate Proceedings (Southern Louisiana Area), 25 FPC 942 (1961)	4
Area Rate Proceedings (Southern Louisiana Area), 40 FPC 530 (1968)	10
Area Rate Proceedings (Texas Gulf Coast Area), Docket No. AR64-2, —— FPC —— (Opinion No. 595, May 6, 1971), rev'd. *sub nom. Texas Gulf Coast Area Natural Gas Rate Cases (Public Service Commission for the State of New York* v. *FPC, et al.)*, —— F. 2d —— (Nos. 71-1828, *et al.*, D.C. Cir., August 24, 1973)	20
Pipeline Costs Allocable to the Transportation of Liquids, Liquefiable Hydrocarbons, etc. for Others, Docket No. R-338, FPC Order No. 449 (January 31, 1972), rev'd, *sub nom. Mobil Oil Corp.* v. *FPC*, —— F. 2d —— (No. 72-1471, D.C. Cir., July 11, 1973)	18, 30, 31
Reef Fields Gasoline Corp., 19 FPC 351 (1958)	22
Socony Mobil Oil Co., Inc., 31 FPC 1101 (1964)	9
Transcontinental Gas Pipe Line Corp., 28 FPC 979 (1962)	21

STATUTES:

Natural Gas Act, 52 Stat. 821 (1938), 15 U.S.C. § 717, *et seq.*:

Section 4, 15 U.S.C. § 717c	2 and cited throughout
Section 5, 15 U.S.C. § 717d	2 and cited throughout
Section 7, 15 U.S.C. § 717f	22, 30
Section 19, 15 U.S.C. § 717r	2, 4, 15, 19, 29

TABLE OF AUTHORITIES—Continued

Page

RULES AND REGULATIONS:

Federal Power Commission Rules of Practice and Procedure, 18 C.F.R. § 1, *et seq.*:

18 C.F.R. § 2.56 *(Statement of General Policy No. 61-1,* 24 FPC 818 (1960); *Fourth Amendment to Statement of General Policy No. 61-1,* 26 FPC 661 (1961)) 9, 22

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FEDERAL POWER COMMISSION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Mobil Oil Corporation (Mobil) petitions for a writ of certiorari to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered in this case on April 16, 1973.

OPINIONS BELOW

The opinion of the Court of Appeals (Appendix C, pp. 5-61) is not yet reported. The opinions and orders of the Federal Power Commission are reported at 46 FPC 86 and 46 FPC 633.[1]

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[1] Appendices to this Petition are filed under separate cover and include the judgment, opinions, and orders of the Court of Appeals. With those Appendices, petitioner has filed forty copies of the volume of the printed Joint Appendix in the Court of Appeals con-

JURISDICTION

The judgment of the Court of Appeals was entered on April 16, 1973 (Appendix A, pp. 1-2). Timely petition for rehearing was denied by order entered June 11, 1973 (Appendix B, pp. 3-4), and this petition is filed within ninety days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

QUESTIONS PRESENTED

In "area rate" proceedings under Sections 4 and 5 of the Natural Gas Act to fix maximum rates for producers' sales of natural gas in onshore and offshore Southern Louisiana which provide approximately 33% of national supply, the Federal Power Commission adopted an opposed "settlement" providing (1) a formula for "forgiveness" of refunds of approximately $150,000,000 owed by area producers, (2) a structure of maximum area rates for "flowing" and "new gas" tied to this formula, (3) "moratoria" on rate increases extending to 1976 and 1977, (4) mandatory minimum charges by pipelines to producers for transportation of liquids and liquefiable hydrocarbons, and (5) no allowances for producers' royalty payments above the prescribed area rates. The Court of Appeals affirmed, and questions presented are:

1. Whether standards of Sections 4 and 5 of the Natural Gas Act prohibiting unduly discriminatory, un-

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taining the opinions and orders of the Federal Power Commission. References to that volume are by the pagination used below, *e.g.*, R. 13,569. As a Supplement to the Appendix to this Petition, petitioner also is filing forty copies of the opinion of the United States Court of Appeals for the District of Columbia Circuit issued August 24, 1973 in *Texas Gulf Coast Area Natural Gas Rate Cases*, —— F.2d —— (No. 71-1828, D.C. Cir.), which is cited in this Petition.

duly preferential, anti-competitive and unreasonable rates are violated by a "refund credit" formula which favors a few area producers who collected the highest rates in the past, provides additional working capital for such producers, imposes maximum area rates on all other producers without comparable capital allowances, and requires all other producers to "earn" rate escalations that will be equally available to the few producers already so favored by the "refund credit" formula.

2. Whether maximum area rates imposed on producers not favored by the "refund credit" formula provide an adequate rate of return, allowances for exploration and development, and coverage of revenue requirements consistent with the "just and reasonable" standard of Sections 4 and 5 of the Natural Gas Act, the "end result" test of *Federal Power Commission* v. *Hope Natural Gas Company*, 320 U.S. 591 (1944), and the "area rate" test of *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

3. Whether "moratoria" on access to rate changes under Section 4 of the Natural Gas Act, extending to October 1, 1976 for one class of sales and to October 1, 1977 for another, are unjust, unreasonable and unsupported by required findings of fact and substantial evidence under criteria for valid "moratoria" set out in *Permian* as to projections of future stability of costs and revenue requirements.

4. Whether mandatory "minimum charges" by pipeline companies to producers for transportation of liquefiable hydrocarbons and liquids are unjust and unreasonable, supported by required findings of fact upon substantial evidence, and otherwise adopted in accordance with limitations on the scope of the "area rate" proceeding.

5. Whether in computing and determining costs, reve-

nue requirements, and area rates, the Commission unlawfully failed to allow for, or provide adjustment for, payment by producers of royalty computed on bases exceeding the producers' filed and effective rates under final orders issued under the Natural Gas Act.

STATUTES INVOLVED

Sections 4, 5 and 19(b) of the Natural Gas Act, 52 Stat. 821, 822, 831 (1938), 15 U.S.C. §§ 717c, 717d, 717r, are involved and are reproduced at Appendix D, pp. 65-69.

STATEMENT

Mobil is an "independent producer" of natural gas regulated by the Commission since June 7, 1954, and is a substantial seller in Southern Louisiana.[2] Prior history of Southern Louisiana area rate proceedings is set forth in *Southern Louisiana Area Rate Cases (Austral Oil Co. v. FPC)*, 428 F. 2d 407 (5th Cir.), *cert. den.* 400 U.S. 950 (1970) (the *Austral* case), and is summarized in the opinions on review (Op. 598, R. 13,569-13,574).

1. *Proceedings before the Commission.* By order issued March 29, 1969, the Commission initiated area rate proceedings in Docket No. AR69-1 under Sections 4 and 5 of the Act to consider modifying certain of the rates for natural gas producers in Southern Louisiana fixed by the opinions reviewed in *Austral.* Subsequent orders expanded the scope of the proceeding and provided for reconsideration of all rates and refund liabilities under the opinions reviewed in *Austral.* Formal hearings commenced on May 26, 1970, and with various recesses, continued until March 11, 1971.

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[2] This area is that portion of the State of Louisiana lying south of the 31° parallel, including both State and Federal domains offshore Louisiana in the Gulf of Mexico. *Southern Louisiana Area Rate Proceeding*, 25 FPC 942 (1961).

At the formal hearings, a broad range of evidence was submitted on economic and supply issues, including presentations by a producer group in which Mobil participated, groups of intervening distribution companies, the pipeline purchasers group, and the Commission's Staff. With 1969 as the "test year," these presentations covered the subjects previously considered in fixing area rates.

On April 1, 1970, at the request of certain parties, the Examiner convened a settlement conference pursuant to the Commission's Rules of Practice and Procedure (see R. 11,501). While formal hearing continued, various sessions of this conference were held off the record. On November 6, 1970, the distribution companies styled UDC filed a motion for "promulgation" of a settlement proposal, alleging that a proposal appended thereto had the support of most of the other parties. On November 9, 1970, the Commission issued notice of the filing of this proposal, providing thirty days for responses or other pleadings objecting to or supporting this proposal.

Endorsements of the UDC proposal were filed by the pipeline purchasers, various state commissions, the Commission's Staff, and numerous producers. Certain other producers endorsed the proposal with express reservations, and pleadings opposing the proposal were filed by Mobil, Amoco Production Company (Amoco); Memphis Light, Gas and Water Division; Public Service Commission of the State of New York (New York); American Public Gas Association; American Public Power Association and the Consumer Federation of America. On widely varying substantive grounds, these parties sought either substantial modification of the proposal or rejection of that proposal and adoption of alternatives. Nevertheless, by order issued December 24, 1970, the Commission made the UDC proposal a part of "the record" in its entirety.[3]

[3] On the same day, the Commission lifted the "moratorium" on changes in rates for Southern Louisiana sales which had been in

2. *Evidence on Rate Structure and the Proposed "Settlement"*. In pertinent part, the "settlement" proposal provided:

(1) Area Ceiling rates (in cents per thousand cubic feet (Mcf) at 15.025 psia) for natural gas sold under contracts dated *prior* to October 1, 1968 of 22.375 cents onshore and 21.375 cents offshore; and for natural gas sold under contracts dated *on or after* October 1, 1968 of 26.0 cents both onshore and offshore;

(2) Fixed escalations in rates for natural gas sold under contracts dated *prior* to October 1, 1968 of 0.5 cents per Mcf on October 1, 1973; and for natural gas sold under contracts dated *on and after* October 1, 1968 of 1.0 cents per Mcf on October 1, 1974;

(3) Contingent escalations in rates for natural gas sold under contracts dated *prior* to October 1, 1968 of 0.5 cents per Mcf if, prior to October 1, 1977, new reserves dedicated in Southern Louisiana to the interstate market by the producing industry as a whole total 7.5 trillion cubic feet; an additional 0.5 cents per Mcf if, prior to October 1, 1977, such reserves total 11.25 trillion cubic feet; and an additional 0.5 cents per Mcf if, prior to October 1, 1977, such reserves total 15 trillion cubic feet.

(4) Moratoria on rate increases until October 1, 1976 for natural gas sold under contracts dated *prior* to October 1, 1968; and until October 1, 1977 for natural

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effect since October 1, 1968, but (1) imposed the rates in the "settlement" proposal as "ceilings" on rate increases, and (2) provided for summary rejection of all rates exceeding those listed in the proposal. Mobil sought review of this order and related orders summarily rejecting increases filed by Mobil. However, these orders were affirmed in *Mobil Oil Corporation* v. *Federal Power Commission*, 469 F. 2d 130 (D.C. Cir. 1972), *cert. den.*, 412 U.S. 931 (1973), pet. for reh. pending (No. 72-1108).

gas sold under contracts dated *on or after* October 1, 1968;

(5) A total refundable amount of $150,000,000 computed by application of rates for natural gas sold for past periods and a formula set out in the proposal but with provisions that (1) any producer owing refunds may be relieved by a credit of 1.0 cents for each Mcf of new gas reserves committed to the interstate market in Southern Louisiana, and (2) any such reserves so "used" cannot be counted in computing reserves to earn the contingent escalations for the industry as a whole, referred to *supra*.

(6) Mandatory minimum transportation charges to be made by pipeline companies to producers for transportation of liquids and liquefiable hydrocarbons computed on the basis of two-hundredths of a cent (.02 cents) per Mcf per mile for liquefiable hydrocarbons and related fuel, and twenty cents (20 cents) per barrel for liquid hydrocarbons.

Other provisions cover definitions of certain sales, a system for reporting dedication of new gas reserves to permit policing of the contingent escalation and refund provisions, quality standards and delivery points, and applicability to pending certificate applications and other dockets involving refund liabilities.

Thereafter, in proceedings on the formal record, evidence concerning area rate structure and impact and opposition to the "settlement" proposal was served, and hearings for cross-examination of this phase of the evidence continued until the record closed on March 11, 1971.

UDC presented one witness sponsoring statistical data showing application of the proposal to refunds, area sales volumes, and past and projected revenues for individual producers. The pipeline purchaser group presented two

witnesses in support of the proposed transportation charges by pipelines to producers for liquefiable hydrocarbons and liquids. The Commission's Staff presented one witness with a separate, alternative rate design presentation, but who endorsed the UDC proposal as "reasonable." The Municipal Distributor Group (MDG) presented opposition to the UDC proposal and alternative recommendations. The Major Producer Group presented two witnesses who testified as to why rates reviewed in *Austral* were too low and higher rates are required and presented comparisons between various proposed rate levels and actual average revenues available to producers after applying existing contract limits on rate increases.

Mobil presented testimony as to grounds of opposition to the proposal and Mobil's alternative proposed rate structure. *Inter alia*, Mobil argued that this and other evidence showed that the refund liabilities involved exceeded $376,000,000 through 1970 under the rates fixed by the opinions reviewed in *Austral*, and $150,000,000 under the new rates substituted in the UDC proposal; that these refund liabilities are not uniformly distributed over the area producing industry, but are owed by a relatively small number of producers who collected the highest rates in the past; that only four companies account for more than 40% of the total refunds due, and that twenty-three companies account for over 82% of the refunds owed, with the remainder spread over the hundreds of other regulated producers in Southern Louisiana; and that under the UDC proposal, none of these amounts collected at rates in excess of the just and reasonable rates need be refunded, but the producers owing such refunds would be permitted to retain such funds for unrestricted corporate purposes and to avoid cash refunds by receiving credit against their refund obligations for new reserves dedicated by them.

Mobil objected to these provisions on grounds, *inter alia*, that the rates and rate design are anti-competitive and unlawfully discriminate in favor of a few producers who have collected rates in excess of the just and reasonable rates and against producers whose past rates have been at lower levels under past Commission guidelines and orders and who already have made substantial cash refunds.[4] Mobil showed that in operation and effect, the UDC scheme thus would:

(1) permit the sellers who already collected large amounts at rates in excess of the just and reasonable rates an added bonus above flowing gas rates for the past and for the future;

(2) make available, on a preferential basis, substantial amounts of additional working capital to be used by these preferred sellers in competitive lease bidding in Southern Louisiana and for other unrestricted corporate purposes;

(3) provide such a special "incentive" allowance only for these preferred sellers, not made generally available to all area sellers of flowing gas;

(4) allow the same few preferred sellers the full benefit of industry-wide escalations in flowing gas rates that would be earned by dedication of new reserves by *other* producers, even though the new reserves of these few preferred sellers are counted only in reducing their own individual refund liabilities;

(5) authorize higher realization from new reserves for the few preferred sellers, substantially above that made available to other sellers or new entrants under the "new gas" rate;

(6) create an anti-competitive, preferential pricing system favoring one group of existing sellers and dis-

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[4] See *Statement of General Policy No. 61-1*, 24 FPC 818 (1960); *Fourth Amendment to Statement of General Policy No. 61-1*, 26 FPC 661 (1961); *Socony Mobil Oil Co., Inc.*, 31 FPC 1101 (1964).

criminating against other existing sellers and new entrants competing for leases, reserves, and sales in the area;

(7) establish an anti-competitive pricing structure providing preference and discrimination in favor of existing buyers and against new entrants on the buyers' side competing for new gas reserves;

(8) force all area sellers, in effect, to absorb the impact of the few preferred companies' refund liabilities through lower realization from flowing gas and new gas and through the obligation to "earn" escalations for "the industry," including the preferred sellers, while these few preferred sellers use their new reserves to discharge their individual company liabilities.

By reference to evidence in the record, Mobil also argued that, *inter alia*, (1) the ceiling rates proposed by UDC were below producers' revenue requirements and do not meet criteria set out in *Permian*, (2) provisions such as the moratoria were unsupported and unreasonable, and (3) the mandatory pipeline charges for transportation of liquids and liquefiable hydrocarbons were unsupported and excessive, were already at issue in another Commission docket, and outside the scope of the area rate proceeding.

After closing of the record and omission of a decision by the Examiner, briefs were filed directly with the Commission on April 15, 1971 and May 6, 1971. There was no oral argument before the Commission.

3. *The Commission Opinions.* Commission Opinion No. 598, issued July 16, 1971, adopted the UDC "settlement" proposal without modification (R. 13,546-13,733).

The Commission noted review of the earlier Opinion No. 546 in *Austral*, but concluded that its prior Opinions Nos. 546 and 546-A "now perform no office" and that the

scope of its new order should extend to sales initiated both prior to and after October 1, 1968, and to the question of refunds. Under the heading of "rationale" for acceptance of the UDC proposal, the Commission stated (R. 13,580):

> "It is our duty to review that record and to make findings thereon, and to come to conclusions therefrom. Only if substantial evidence supports it can we approve the settlement proposal, and this means that we must analyze supply and demand, supply-cost relationships, and costing methodology."

The Commission then referred to objections to the UDC proposal. Objections of New York and MDG were first rejected, and the Commission then turned to the position of Mobil. The Commission noted the argument that producers who collected the highest rates in the past at levels above the just and reasonable rates are favored:

> "Under the proposed settlement, as Mobil points out, one group is in effect rewarded for their relative intransigeance—they will be able to retain revenues collected up to the agreed 22.375¢ (where their contracts permit) and achieve a favored revenue position." (R. 13,586, fn. omitted)

Referring to alternative rate design proposals by Mobil, the Commission noted that this rate structure provided for a higher price for new gas "coupled with a procedure for retrospective achievement of equity among Southern Louisiana producers," but concluded (R. 13,586):

> "The logic of this position cannot be assailed. Candor requires us to admit that some of the predicted inequities as among producers will surely occur and those who have attempted to work within the system are comparatively disadvantaged. We have chosen to go the route of the alternative rate design suggested in the UDC proposal. The inequitable consequences which might flow from it have to be com-

pared with its advantages, and as our later sections of this Opinion will make more clear, no scheme can be free of some inequities. The broader acceptability of the UDC proposal with the distributor group impels us to act as we do."

Thus, impelled to adopt the "scheme" submitted by UDC, the Commission then discussed *seriatim* various categories of evidence. The Commission found "a critical shortage of gas in the United States" (R. 13,591), and that it "is from the Southern Louisiana area that we reasonably can expect the greater portion of total demand for jurisdictional gas to be satisfied in the next few years" (R. 13,600). Supply-price relationships were reviewed, with conclusions that "no reliable quantitative forecasts may be made," and that "adequacy of expanded gas exploratory activity in terms of sufficiency of gas supply in relation to gas demands must be determined by continued observation of the results of our decisions" (R. 13,608). Industry consequences were reviewed, including evidence as to increased industry capital requirements, and the conclusions were stated that the instant decision would make more capital available, attract "new entrants," and "have an overall tendency to be procompetitive" (R. 13,614).

Costs were reviewed by reference to "current costs" (R. 13,616-13,628), including a summary of each component as to which there was a dispute and findings that a rate of return of approximately 15 percent is "just and reasonable" (R. 13,615-13,626); that there was "a variable range of reasonable costs of 4-5 cents per Mcf"; that the 26 cents *new gas* rate in the "settlement" is "within the zone of reasonableness of costs" and "will elicit exploratory and developmental effort in Southern Louisiana" (R. 13,626), and "would be at a competitive price level with the market price for intrastate gas" (R. 13,627).

Flowing gas (*i.e.*, gas sold under contracts dated prior to October 1, 1968) was reviewed in relation to four flowing gas cost studies "using mainly 1969 data" (R. 13,628). The Commission noted differences in methodology, need for funds from the "realization" for flowing gas, and details of the presentation of the Commission's Staff in which a 13% rate of return was used (R. 13,629-13,631). Nevertheless, no express findings or conclusions as to such costs were made, in terms of a "zone of reasonableness" or otherwise, although the Commission concluded that the rates of 22.375 cents onshore and 21.375 cents offshore were "just and reasonable" (R. 13,632).[5]

From the UDC proposal, the Commission also adopted contingent adjustments of flowing gas prices tied to possible future dedications of new gas reserves (R. 13,632-13,633); effective dates to provide, *inter alia*, that rate increases to the rates adopted "shall not be effective until 65 days" from the date of the Commission order (R. 13,633); the mandatory minimum transportation charges to producers by pipeline companies, although the Commission recognized "certain difficulties in approving the provision" (R. 13,634); moratoria without findings or other discussion, to October 1, 1976 for contracts dated prior to October 1, 1968, and to October 1, 1977, for contracts dated on or after October 1, 1968 (R. 13,635); and all provisions as to treatment of refunds (R. 13,635-13,638).

On another contested issue, the Commission predicated its rates on the assumptions that producers' payments to royalty owners will (1) exceed 15% of producers' total revenues, but (2) be based on the area rates prescribed in

[5] The Commission made no findings as to what the average revenues would be at such rates and as to what the rate of return actually to be earned would be, even though exhibits were in the record from which these determinations can be made.

the opinions. The Commission thus treated the royalty amount as "derivative" from the 26 cents "new gas" rate (R. 13,622; R. 13,624-13,625); and in review of "flowing gas" costs, referred to studies based on 1969 costs. Mobil contested the omission of a provision to compensate producers for payment of royalties computed on bases exceeding the area rates on grounds (1) that the level of royalty payment is not subject to Commission jurisdiction or the area rate ceiling under construction of the Natural Gas Act in *Mobil Oil Corporation* v. *Federal Power Commission*, 463 F. 2d 256 (D.C. Cir. 1971), *cert. den.*, 406 U.S. 976 (1972); (2) that producers are confronted with continuing and increasing claims for payments based on increased "market value" and prices far in excess of the Commission-prescribed area rates; and (3) that payments on these higher bases deprive producers of substantial revenues the Commission has assumed to be available to cover other costs, exploration and development expenditures, and return allowances. Nevertheless, the Commission made no provision to cover adjustment for producers' payments to royalty owners computed on bases above 1969 levels and on the basis of "values" exceeding Commission-prescribed area rates (R. 13,629-13,631).

Mobil and others opposing the UDC proposal filed applications for rehearing, and some of the parties supporting UDC sought modification of Opinion No. 598 where language was inconsistent with the UDC proposal (R. 13,953). By Opinion No. 598-A, issued September 9, 1971 (R. 13,951-13,971), the Commission denied all applications for hearing but modified its opinion in each and all respects to conform to the UDC proposal. On issues pertinent here, New York had objected to failure of the Commission to order refunds and to unduly discriminatory and preferential features of the UDC proposal, and the Commission confessed (R. 13,957):

> "Furthermore, refunds as a part of that package represented a policy decision; if such a policy decision had not been made as it was, the price for new gas might well have been greatly higher."

The Commission further stated (R. 13,961):

> "We did, in fact, accept the settlement proposal in its entirety."

Petitions for review under Section 19(b) of the Natural Gas Act followed, and all such petitions ultimately were transferred to and consolidated before the United States Court of Appeals for the Fifth Circuit.

4. *The Court of Appeals Opinions.* The court below affirmed the Commission's opinions in their entirety, finding each contested part valid and that Commission Opinion No. 598 "is supported by 'substantial evidence on the record as a whole'" (App. C, p. 5).

First, the court summarized prior history of producer rate regulation and traced proceedings to fix Southern Louisiana rates through *Austral* and to the present case (App. C, pp. 6-15). Propriety of use of the opposed "settlement" as the basis for decision was reviewed and affirmed (App. C, pp. 20-23). Data as to existence of a shortage of natural gas and the potential and future importance of Southern Louisiana as a supply area were reviewed (App. C, pp. 23-29). Provisions of the rate structure were treated as an interrelated "triumvirate of incentives" consisting of (1) flowing gas and new gas rates to "encourage exploration and development," (2) the formula for treatment of the recomputed $150,000,000 refunds, and (3) the provisions for periodic escalations in the rates and for contingent escalations in the flowing gas rates dependent upon future dedications by the industry as a whole. The court found this structure "amply supported" (App. C, pp. 30-51).

On specific issues raised by Mobil and others, the opinion is less clear as to bases for affirmance:

(1) Mobil contested prescription of flowing gas rates on the basis of a 13% rate of return when the Commission *found* a 15% rate of return "just and reasonable" and used 15% as component in the rates for new gas. However, the court's review of components of the flowing gas rates is not addressed to the issue of rate of return for flowing gas but to separate questions of the allowance for exploration and development expenses (App. C, pp. 30, 32-34), and after this discussion the flowing gas rates were "sustained" (App. C, p. 34).

(2) Mobil contested the inadequacy of allowances for exploration and development in the new gas rates, particularly because of deficiencies for all area producers who were not provided extra working capital by the preferential retention of refund amounts. However, until corrected on rehearing (App. B, pp. 3-4), the court considered these rates on the assumption that "no party" had contested the new gas rate level as too low (App. C, p. 34). The court reviewed the components of the rate as within a "zone of reasonableness" as to costs (App. C, pp. 34-39); and "sustained" the rates (App. C, p. 39).

(3) The issues as to violation of standards of Sections 4 and 5 of the Act by the provisions for refunds and interrelated rate levels were noted and reviewed under the "substantial evidence" test (App. C, pp. 45, 49, 51), although the court first noted the questions

> "(ii) that the refund credit program arbitrarily and capriciously discriminates against producers, like Mobil and Amoco, who have entered into voluntary company-wide settlement agreements by which they have already made substantial refunds and reduced the rates for flowing gas in favor of relative intransigents . . . who have continued to charge rates sub-

ject to refund now found to be excessive." (App. C, p. 40).

In response to arguments by New York and others, the court found the Commission "empowered" to adopt a structure for forgiveness of refund liabilities (App. C, pp. 41-42). As to specifics of *this* structure, the court noted that ". . . even FPC recognized that the cosmic plan which it adopted has some atomic flaws" (App. C, p. 45), but concluded that it ". . . will not reject an administrative decision merely because one producer's piece of cake is iced and another's is not" (App. C, p. 45). The court did take note of the issues raised by the unduly discriminatory, preferential, and anti-competitive impact of the UDC scheme and to the features of "industry-wide . . . benefits," but "individualized . . . in-put" (App. C, p. 46); and the effects of provisions under which ". . . Amoco, Mobil, and others who have worked within the system and made voluntary company-wide settlement agreements and substantial refunds will have to credit their new additions to the interstate market towards the target goals which trigger the contingent escalations . . ." while others ". . . will be able to reap the benefits by collecting the additional revenue for their sales of flowing gas . . ." (App. C, pp. 46-47). In sum, however, the court treated Commission authority as purely "discretionary" and the result as not in conflict with *Permian* or prior decisions of the Fifth, Ninth, and District of Columbia Circuits as to obligations of the Commission to apply refund formulae equitably and without undue discrimination and preference (App. C, pp. 47-49).

(4) Provisions for future escalations tied to the refund credit system similarly were treated solely as matters of administrative discretion and sustained "in full" (App. C, pp. 49-51).

(5) Moratoria on access to rate increases under Section 4(e), extending to 1976 and 1977, were sustained without specific reference to record evidence or impact on the "disadvantaged" producers, but on the basis of the "safeguards" for the few preferred sellers under the provisions "for the retention of large amounts of capital through the refund discharge program and the periodic and contingent escalations;" alternative procedures for a "single aggrieved" producer to establish higher rates; and the assumption that despite the court's affirmance, the Commission will retain "power" to lift the moratoria (App. C, pp. 41-52).

(6) The mandatory minimum rates for pipeline charges to producers for transportation of liquids and liquefiable hydrocarbons were sustained on the grounds that the Commission had "a substantial evidentiary basis" for these charges (App. C, p. 57).[6]

(7) On the question of inadequate provisions to cover increased payments of royalties by producers, the court recognized the absence of Commission authority to control these payments at the level of the area rates and that increased payments will deprive producers of revenues assumed to be available under the area rates (App. C, pp. 55-56), but affirmed Commission treatment on the ground that the Commission could adjust the rates on "individualized" bases in the future (App. C, p. 56).

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[6] The court also referred to the Commission's Order No. 449 issued on January 31, 1972, establishing minimum rates for these charges on a nationwide basis. However, on July 11, 1973, the Court of Appeals for the District of Columbia Circuit reversed and remanded Order No. 449 on grounds that the Commission does not have jurisdiction to establish rates for transportation of liquids, that the rates for liquefiable hydrocarbons are the products of procedures violating rulemaking and hearing requirements of the Natural Gas Act, and that substantial evidence on the whole record did not support the rates promulgated. *Mobil Oil Corporation* v. *Federal Power Commission*, —— F. 2d —— (No. 72-1471, D.C. Cir., decided July 11, 1973).

The Commission also was affirmed on other questions not raised here (App. C, pp. 53-55, 57).

Because of errors and the omissions of express decisions upon issues squarely raised, Mobil sought rehearing. However, by its opinion issued June 11, 1973, the court denied the petition, correcting its opinion only to reflect that Mobil and another party had, in fact, sought reversal of the new gas rates (App. B, pp. 3-4).

Questions presented by Mobil thus are ripe for consideration here under Section 19(b) of the Natural Gas Act.

REASONS FOR GRANTING THE WRIT

The questions presented are of major importance and nationwide applicability in the administration of the Natural Gas Act, arise because of novel departures from the principles of area rate-making approved by this Court in *Permian*, and, in particulars, result from conflicts between holdings by the court below and prior constructions of standards of Sections 4 and 5 of the Natural Gas Act by the Fifth, Ninth, and District of Columbia Circuits.

In addition, the holdings below as to validity of the refund credit formula and related rate structure are now in conflict with the opinion of the United States Court of Appeals for the District of Columbia Circuit decided August 24, 1973, in *Texas Gulf Coast Area Natural Gas Rate Cases*, —— F. 2d —— (No. 71-1828, D.C. Cir.), copies of which are filed as a Supplement to the Appendix to this Petition.

1. The Questions of Unreasonable, Unduly Discriminatory and Preferential Rate Structure and Treatment of Refunds Are of Nationwide Applicability and Arise Because of Violation of Principles Approved In *Permian* and Conflicts In Constructions of Sections 4 and 5 of the Natural Gas Act by the Court of Appeals

Treatment of refunds and the "refund credit" scheme reviewed below directly apply to all producers' sales of natural gas in interstate commerce in an area now supplying more than 33% of national supply and involve hundreds of millions of dollars in a rate structure affecting consumers in 27 states and the District of Columbia. In addition, the Commission now has applied the same novel, controversial formula to rates prescribed by it for other areas supplying approximately 75% of all natural gas sold by producers subject to Commission jurisdiction.[7]

This case is the first of a series to reach appellate decision, but the holdings, in impact and scope, are of nationwide applicability to lawful producer rates and "incentive" pricing during a shortage of domestic supplies of natural gas. Precedents for all existing area rate decisions thus are involved at a critical time in administration of the Act; and on these issues, there now is a square conflict with the opinion of August 24, 1973, by the District of Columbia Circuit in the *Texas Gulf Coast Area Natural Gas Rate Cases, supra,* (slip. op., pp. 47-70).

In *Permian,* this Court approved the use of group proceedings to fix rates for producers on area bases and de-

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[7] See *Texas Gulf Coast Area Rate Case,* —— F. 2d ——, (No. 71-1828, D.C. Cir., decided August 24, 1973); *Other Southwest Area Rate Case,* —— FPC —— (1971), aff'd, *sub nom. Other Southwest Area Rate Case,* —— F. 2d —— (No. 72-1114, *et al.,* Fifth Cir., decided June 8, 1973); *Permian Basin Area Rate Proceeding II,* —— FPC —— (Opinion No. 662, Docket No. AR70-1 (Phase I), August 7, 1973).

parture from regulation by reference to individual producers' costs. *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). Throughout that opinion, however, this Court emphasized the Commission's obligations to design rate structures to avoid undue preference and discrimination and to treat sellers within a given area fairly and equitably. This Court thus cited requirements that "maximum rates must be calculated for a regulated class in conformity with pertinent constitutional limitations"; that price control cannot be "arbitrary" or "discriminatory" (390 U.S. at 769-770); and that area rate orders should not produce "arbitrary or unreasonable consequences" (390 U.S. at 799). No suggestion was made that by deliberate, conscious design, the agency could adopt a structure affording special working capital to one group and simultaneously depriving others of adequate rates and an equal opportunity to receive adequate revenues.

Section 4 of the Natural Gas Act prohibits rates which are not just and reasonable and prohibits undue preference or advantage, and Section 5(a) of the Act establishes the substantive standard that no "rule, regulation, practice or contract" affecting a rate may be "unjust, unreasonable, unduly discriminatory or preferential." These standards heretofore have applied to any rates fixed by the Commission, and it cannot *impose* an unduly discriminatory, unduly preferential rate structure.[8] While the District of Columbia Circuit has now found the new formula in violation of these requirements and of the standards of the Act, the Fifth Circuit has erred in concluding otherwise (See Supplement to Appendix, pp. 60-70).

In the past, the Commission expressly had recognized that in the application of the Act to producers' rates, the

[8] See discussions in *Mississippi River Fuel Corp.* v. *FPC*, 252 F. 2d 619 (D.C. Cir. 1957); *Interstate Power Co.* v. *FPC*, 236 F. 2d 372, 380 (8th Cir. 1956); and *Transcontinental Gas Pipe Line Corp.*, 28 FPC 979 (1962).

Commission has a ". . . responsibility to treat those similarly situated with equality consonant in the premises . . ." *Reef Fields Gasoline Corp.*, 19 FPC 351, 352 (1958). The courts also required the Commission to apply its policies as to prices and refunds even-handedly and without discrimination and have reversed orders reflecting inequitable, discriminatory application of policies as to refunds. See *Mesa Petroleum Co.* v. *FPC*, 441 F. 2d 182 (5th Cir. 1971); *Plaquemines Oil and Gas Co.* v. *FPC*, 450 F. 2d 1334 (D.C. Cir. 1971).

Those principles are violated by the holdings below. On September 28, 1960, the Commission put into effect (1) the method of regulation of producers' rates on a group basis, and (2) its Statement of General Policy No. 61-1 expressing the "guidelines" for rate increases under Section 4 and rates for new sales the Commission would accept without a "condition" as to initial rate under Section 7 of the Act.[9] The Commission also had in effect three programs pertinent to questions now presented: (1) encouragement of settlement of contested rate dockets by individual producers by reduction of rates to levels at or near the Commission's "guideline" levels; (2) acceptance of settlement of Southern Louisiana Section 7 cases at levels of 20.625 cents per Mcf onshore and 19.00 cents per Mcf offshore; and (3) determination of "in-line" initial prices for Southern Louisiana, after hearings under Section 7, of 20 cents per Mcf offshore and 18.5 cents per Mcf onshore.

Application of these policies resulted in substantial refunds, reduction of rates to the Commission guidelines, and moratoria on rate increases for substantial periods. A large number of the major producers participated in

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[9] For Southern Louisiana, the levels were prescribed and later modified by amendments to the Policy Statement. See *Statement of General Policy No. 61-1*, 24 FPC 818 (1960); *Fourth Amendment to Statement of General Policy No. 61-1*, 26 FPC 661 (1961).

these programs, but a few did not. For example, between 1960 and October 1, 1968, Mobil refunded to pipelines $12,413,000 and reduced its rates by over $5,000,000 *per annum;* and for Southern Louisiana sales only, Mobil refunded over $4,000,000 (R. 10,806) and, beginning in 1964, reduced current and future rates to levels prescribed by the Commission's various "guideline" statements and decisions in effect between 1960 and 1968.

However, such compliance by Mobil and others with past Commission policy and precedent is now ignored, and undue preference and discrimination are the result of mixing up the individual refund liabilities of a few who did not follow those policies with incentives and rates that, by statute, are supposed to be applied equitably. In fact, the larger the amounts collected at rates above Commission guidelines in the past, the higher the producer's refund debt becomes and the higher would be his benefits and extra working capital allowance under the new scheme of "ratemaking" at issue.

Under the formula now adopted, those who followed Commission guidelines thus would now be forced (1) to compete unequally for working capital and in lease acquisitions with those few who owe most of these refunds, despite the well-documented history of exactly how those refunds accumulated over the past 17 years; (2) to assist in earning "contingent" rate escalations for those few producers who owe most of these refunds, while the "new" reserves of those same producers do *not* "count" to earn escalations for Mobil and the rest of the industry; and (3) to refund 30.5% of certain amounts collected after October 1, 1968 even though the same few producers will retain substantially larger amounts collected at much higher rates on file both before and after October 1, 1968. As the District of Columbia Circuit has held, in concept, operation, and impact, this type of formula of "area rate making" would be anticompetitive, disruptive of competitive conditions, unduly discriminatory, and un-

duly preferential in favor of the relatively small number of producers who collected the highest rates in the past and who still have the highest rates on file in a given area. See discussion by the District of Columbia Circuit in *Texas Gulf Coast Natural Gas Rate Cases, supra* (slip op., pp. 60-70).

Such a scheme obviously will place a premium on ignoring Commission "guidelines," and, as both the Commission and the court below acknowledged, punishes those who attempt to "work within the system" and rewards those producers who collected the highest rates (App. C, pp. 46-47). Evolution of such a formula as a recommended "settlement" does not immunize it from the standards of Sections 4 and 5 and the principles spelled out in *Permian.* Commission action still is supposed to eliminate undue preference and undue discrimination, not create it.

This scheme also is in marked contrast to the area rate structure approved by the Ninth Circuit in *Hugoton-Anadarko Area Rate Case*: *California* v. *Federal Power Commission,* 466 F. 2d 974 (9th Cir. 1972). There, the rate structure and provisions for refunds were designed *to comply* with past Commission orders and policies and *to remove* discrimination against certain producers. The court below attempted to reconcile the formula in the present case with that which was before the Ninth Circuit (App. C, pp. 48-49), but it is plain that in force, effect, and applicability of standards of Sections 4 and 5, the substance of the new formula for rate structures and the constructions of these standards by the court below are in conflict with the substance and constructions of the Ninth Circuit. Similarly, the mandates of the *Mesa* and *Plaquemines* cases, *supra,* were to compel Commission elimination of inequities, and the approval of an unjust, unduly discriminatory scheme by the court below now stands in sharp conflict with these earlier holdings of the

Fifth and District of Columbia Circuits in those cases, and with the August 24, 1973 opinion of the District of Columbia Circuit in *Texas Gulf Coast Area Natural Gas Rate Cases, supra.*

Intermingling of individual company refund obligations with adequate area rates for the industry as a whole, for present and future, has produced these consequences. The Commission and the court below recognized that deficiencies in the rates now allowed for all producers are supposedly covered by the extra working capital allowed under the refund formula. Yet, only a favored few receive these benefits, and continuation of this approach can only mean that in the future, producers must file each and every rate as high as possible in the expectation that future decisions will permit retention of all amounts collected as "working capital," even amounts that may be collected subject to refund at rates later found excessive. No system of area rates or agency "guidelines" should rest upon such an approach.

As noted *supra*, the Commission now has applied the same general formula to other major producing areas covering parts of Alabama, Mississippi, North Louisiana, Arkansas, Oklahoma, Texas, and New Mexico. What began as a "settlement proposal" in one area thus has become a controlling precedent for national applicability. Yet, the principles set out in *Permian*, prior Court of Appeals opinions, and by the District of Columbia Circuit on August 24, 1973, are violated; Sections 4 and 5 of the Act are ignored; and rate structures affecting most consumers of natural gas in the United States are at issue.

The questions of treatment of individual company refunds due under Section 4 of the Natural Gas Act and interrelation with adequate area rates for all producers thus are of major importance and warrant review by this Court. The conflict now existent on these issues be-

tween the Fifth and the District of Columbia Circuits also should be resolved.

2. The Holdings Below as to Adequacy of Rate Levels Conflict With Requirements of *Permian* and the *Hope* Test and Interject Further Controversies In "Area Rate-making" for Natural Gas Producers

The Commission opinions and the opinion of the Court of Appeals make clear that all deficiencies in area rates prescribed for the present and future were treated as somehow compensated by the "working capital" made available under the preferential refund formula for those producers who owe substantial refunds. Particularly for sellers not receiving such benefits, the area rates do not comply with standards of Sections 4 and 5 as construed in *Permian* and *Federal Power Commission* v. *Hope Natural Gas Company*, 320 U.S. 591 (1944).

Controlling tests are plain and spell out specific criteria as to the rate of return to be allowed in fixing rates under the Natural Gas Act. In *Permian*, this Court noted the *Hope* test remained "pertinent" and summarized that test:

> "The Court in Hope found appropriate criteria by inquiring whether 'the return to the equity owner [is] commensurate with returns on investments in other enterprises having corresponding risks,' and whether the return was 'sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.'" (390 U.S. at 790-791)

This Court also expressed the duty of a court reviewing an area rate decision to include the determination of ". . . whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the

public interests, both existing and foreseeable." (390 U.S. at 792; see also 390 U.S. at 806-808)

Here, as in all other area rate cases, a major contested issue is the rate of return on existing capitalized investment to be allowed in fixing rates for flowing gas. In this instance, the Commission had found a rate of return of 15% "just and reasonable" for "new gas" (App. C, p. 37), but the rates for flowing gas *apparently* are tied to a level of 13% without any such findings or reference to the criteria of *Permian* and *Hope*. The opinions indicate an assumption that an allowance for exploration and development may have plugged the gap (App. C, pp. 31-32), or that *all* area sellers somehow are compensated by the refund amounts retained by a few other sellers (App. C, pp. 39-40). In any event, the "triumvirate" of unequal "incentives" does not comport with what is required by the Act, and the court below erred in affirming without even canvassing the question of rate of return for flowing gas rates.

Similarly, the court below has assumed that for both flowing gas and new gas rates, the refund amounts cover required allowances for exploration and development (App. C, pp. 38, 44). Yet, adequate allowances and provisions for coverage of producers' revenue requirements must be in the area rates allowed for *all* producers. Otherwise, as here and in other Commission area rate decisions following this precedent, *Permian* and *Hope* are not followed, and only those producers owing substantial refunds are allowed a total rate structure that may comply with the substantive standards of the Act.

By Commission actions, the structure approved below now appears to be intended to be a permanent feature of area rate-making for all areas, despite the obvious gaps and inequities, unless this Court reviews these interrelated questions of unduly discriminatory, preferential and anti-competitive rate levels and refund treatment. No

provisions for "special relief" can cover all producer sales in all of the major producing areas now subjected to this approach. Review here thus is essential if the methodology approved in *Permian* is, in fact, to remain viable and equitable. Continued applicability and controlling effect of the tests of *Hope* and *Permian* for determining rate of return and reasonable rate levels for all producers also are at issue.

3. Provisions For Moratoria Cannot Be Supported By Treatment of Refunds, and Violate This Court's Holding in *Permian* That Moratoria Must Be Supported By Findings As To Future "Stability of Costs" And Revenue Requirements

As on other issues, the court below approved the imposition of moratoria on rate increases, extending for five and six years from the effective date of the Commission decision, by express reference to the amounts allowed for the few preferred producers in treatment of refunds (App. C, pp. 51-52). This holding similarly violates Section 4, as construed in *Permian*.

In *Permian*, this Court emphasized that express, specific findings are required to justify a moratorium on access to Section 4 (390 U.S. at 771-782); and in *Austral*, the Fifth Circuit had emphasized that "substantial evidence," such as a finding that costs would remain "stable," must support such "encroachment" on the salutary procedures contemplated by Section 4 (428 F. 2d at 430). Yet, here there is no support whatsoever for the duration of more than half a decade adopted by the Commission. No witness appeared to support the provisions, and evidence of other witnesses was *against* such a lengthy moratorium in a period of rising costs, volatile economic changes, and unmet demand (R. 6979).

Any moratorium bars access to seeking "just and reasonable" rates under Section 4 and *precludes* Commission

examination of area rates in light of future, changing economic conditions. *Permian* and *Austral*, therefore, emphasized that a Commission-imposed moratorium must be fully supported by findings as to assumed "stability" of future costs and economic conditions. Yet, virtually all cost data in the record were for 1969; and most parties conceded substantial increases in industry expenditures for exploration and development are required during the 1970's. Moreover, many components of the cost of "flowing" gas are "current" items which increase with rising costs and inflation.

Only five lines in the Commission opinion were addressed to the critical question of these moratoria for more than half of the decade of the 1970s (R. 13,635). Moreover, the court of appeals' affirmance does not rest upon assessment of validity of the "findings" or supporting "substantial evidence." Instead, the court leaned once more on refund allowances for the favored producers and upon the assumption that other required relief can flow from *other* actions in *other* proceedings which are themselves subject to current attack on judicial review under Section 19(b) of the Act (App. C, pp. 52, 59). *Permian* obviously required far more from the Commission, and a court affirmance or reversal on the basis of the content of the agency opinion then before the court. Grounds not expressed by the agency cannot be drawn anew and added by a reviewing court. *Burlington Truck Lines, Inc.* v. *United States*, 371 U.S. 156 (1962); *Securities and Exchange Commission* v. *Chenery Corporation*, 332 U.S. 194 (1947).

The issues as to moratoria, also thus tied by the Commission and the court below to the issues of unduly discriminatory and preferential treatment of refunds, therefore also warrant review here.

4. Commission Orders As To Mandatory Minimum Charges for Transportation of Liquids and Liquefiable Hydrocarbons Have Been Reversed By the District of Columbia Circuit And Were Erroneously Affirmed Below

As a part of its area rate decision, the Commission imposed on producers new mandatory minimum rates to be charged by pipelines for transportation of liquids and liquefiable hydrocarbons (R. 13,634). This transportation generally is for varying distances from offshore platforms or onshore wellheads to processing plants where extraction occurs. Such charges are revenues to the pipelines and reductions in the realization of producers. Such charges heretofore have been fixed by contract-by-contract negotiation between the producer and the pipeline transporter, subject to Commission review in certificate dockets under Section 7 of the Natural Gas Act.

Since February 5, 1968, the question whether the Commission should fix a "minimum" rate for these charges on a nationwide-basis had been pending in Commission Docket No. R-338, a general rulemaking proceeding. On January 31, 1972, the Commission issued its Order No. 449 in this general rulemaking docket prescribing such mandatory minimum rates on a national basis, applicable to all areas including Southern Louisiana, thus superseding the provisions in the Southern Louisiana opinion before the Fifth Circuit.

However, on July 11, 1973, the Court of Appeals for the District of Columbia Circuit set aside Order No. 449 on grounds (1) that the Commission has no jurisdiction over the rates for transportation of liquids, (2) that the procedures used to fix the charges for liquefiable hydrocarbons violated hearing requirements of the Natural Gas Act, and (3) that the "evidentiary" basis for Order No. 449 was defective as a result. *Mobil Oil Corporation* v. *Federal Power Commission*, —— F. 2d —— (No. 72-1471, D.C. Cir.).

In the instant case, the issues of jurisdiction and "hearing" requirements pending in the general rulemaking docket were not decided by the Fifth Circuit. However, the questions of validity of findings and substantial evidence supporting the charges in the Southern Louisiana opinion were before the Fifth Circuit, and Mobil also had raised questions of propriety of imposition of the charges collaterally in view of the earlier pendency of the issues in the Commission's general rulemaking docket applicable to all areas. On these questions, the court below discussed only the question of evidentiary support and concluded that the charges had a "substantial evidentiary basis" (App. C, p. 57). The question of propriety of inclusion of such provisions in the Commission's collateral area rate opinion, in light of the other pending docket and generally applicable, superseding Order No. 449, were not discussed.

The ultimate reached in this part of the opinion below thus is at odds with the result reached on July 11, 1973, by the Court of Appeals for the District of Columbia Circuit. The questions raised as to validity of the holding below as to these minimum charges for transportation, therefore, should be reviewed here.

5. The Question of Lawful Allowances For Producers' Payments To Royalty Owners Is Novel Here and Is Applicable To All Regulated Natural Gas Producers' Rates

The Commission's failure to provide for adjustment to compensate producers for increasing royalty payments directly affects all producers' rates fixed by Commission area rate decisions. While there is no conflict between the Fifth and District of Columbia Circuits in affirmance of such Commission action, the question is new before this Court and, because of national applicability, warrants the earliest consideration here.

In Southern Louisiana, lessee producers pay to their lessors royalty payments exceeding 15% of producers' revenues from natural gas sales (R. 13,625, n. 124). In arriving at total costs to fix area rate ceilings, the Commission considered these payments, but made inadequate allowances, thus reducing realization actually to be retained by producers, and depriving producers of the reality of "just and reasonable" rate levels.

In arriving at "current costs," the Commission treated the amount for royalty payments as "derivative," noting the percentage now exceeds 15%, but made no provision for an allowance exceeding mechanical application of this percentage to the ceiling rate of 26 cents (R. 13,622-13,624-13,625). In discussing flowing gas costs, the Commission discussed studies based on the 1969 average costs of producers, but similarly made no provision for royalty payments exceeding levels paid during the 1969 test year or exceeding the rates actually to be received by producers (R. 13,629-13,631).

The Commission's conclusions in this case were based on the assumptions that the royalty interest, like the producers' working interest, is subject to Commission jurisdiction, and that Commission-prescribed "area rate" ceilings are equally controlling on the royalty owner. However, in *Mobil Oil Corporation* v. *FPC*, 463 F. 2d 256 (D.C. Cir. 1971), *cert. den.*, 406 U.S. 976 (1972), the Commission was reversed as to the exercise of jurisdiction over royalty interests. The court there held that royalty owners could maintain collateral suits to recover payments based on alleged "current market values," and Commission-prescribed rates need not operate as a ceiling. Therefore, none of the assumptions as to Commission-controlled ceilings on royalty payments are correct. Royalty payments will exceed the levels used in arriving at costs to fix rates, and realization to producers will be reduced to the extent that royalty payments exceed those

assumed by the Commission and are based on "current market value" as determined from time to time for the periods covered by the Commission's area rate orders.

Provisions for royalty payments in the instant case thus are inadequate and rest on erroneous assumptions. For past and future periods, royalty owners may succeed in recovery on the basis of "value" even where the producers' filed rates under the Act were lower under contract limitations or Commission orders under Sections 4 and 5 of the Act. Yet, in the instant case, "costs" are based on the 1969 "test year" cost levels, which in turn, were based on producers' actual payments in the past. Therefore, the Commission has understated the costs, even under its own opinions; if producers are to pay higher royalty, a "known adjustment" exists, and provision also must be made for an upward adjustment in area rates to cover royalty payments exceeding the level of payments actually made in the past.

In any event, the Commission has made inadequate provision for increases in the royalty payments. Suits have already been instituted by royalty owners against producers seeking recoveries on bases far exceeding Commission-prescribed area rates. For example, the State of Texas has filed an original petition in the District Court of Travis County, Texas, 53rd Judicial District, against Mobil seeking recovery on the basis of "market price" instead of Commission-regulated ceiling prices. It is Mobil's understanding that numerous similar petitions have been filed against other producers.

In *Permian*, this Court recognized that royalty payments are to be recoverable by producers in the realization received by them under Commission-prescribed rates, and that principle must be properly applied. The Commission has erred in ignoring the revenue squeeze resulting from its treatment of the issue and in failing to include a provision for upward adjustment in the producer's

"applicable area rate" to the extent that the producer is required to make payments of royalty on bases exceeding the producer's filed and effective rates under Section 4 of the Act during any of the time periods covered by the Commission's orders.

These questions of relationship of adequate royalty allowances to prescribed area rates thus also are of national importance warranting this Court's consideration.

6. In the Face of a Shortage of Natural Gas, the Questions Presented As To Lawful Area Rate Structures Under the Natural Gas Act Are of Critical Importance And Should Be Resolved By This Court

This case establishes far-reaching precedent for all producers' regulated natural gas rates in a time of domestic shortage of supply. The lawful area rate methodology contemplated by *Permian* has been disregarded and eroded by the holdings below, and new controversies and conflicts between the Circuits have been created because of such disregard of *Permian* and the standards of the Natural Gas Act.

The inevitable consequences are that rates provided by the Commission opinion cannot provide an adequate supply, and an unduly discriminatory, preferential, and anticompetitive rate structure would be imposed upon producers of natural gas. Such results cannot be to the long-range benefit of any segment of the natural gas industry or the consuming public. Confidence of all affected interests in the integrity of agency processes also is involved, and there is no margin for error left for producers or consumers when rates are fixed and frozen for over half of the decade of the 1970s on the basis of an opposed "settlement" and by violations of the Act's standards and of the *Hope* and *Permian* tests. What this Court had made clear, the court below has confused.

The issues have been made even more critical by subsequent agency action extending the same formula and defective rate structure to area after area and by the conflicts between the holdings of the Fifth and District of Columbia Circuits. Remedial steps thus must be prompt if the vital interests committed to Commission jurisdiction ever are to be afforded the consideration and protection intended by Congress, and if the objectives of an adequate supply of natural gas at reasonable rates are to be met.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-437

MOBIL OIL CORPORATION,
Petitioner

v.

FEDERAL POWER COMMISSION

APPENDICES TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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TABLE OF CONTENTS

		Page
APPENDIX A:	Judgment of the United States Court of Appeals for the Fifth Circuit, *Placid Oil Company, et al.* v. *Federal Power Commission,* Nos. 71-2761, *et al.,* April 16, 1973	1
APPENDIX B:	Opinion of the United States Court of Appeals for the Fifth Circuit on Petitions for Rehearing, *Placid Oil Company, et al.* v. *Federal Power Commission,* Nos. 71-2761, *et al.,* June 11, 1973	3
APPENDIX C:	Opinion of the United States Court of Appeals for the Fifth Circuit, *Placid Oil Company, et al.* v. *Federal Power Commission,* Nos. 71-2761, *et al.,* April 16, 1973	5
	Letter of April 20, 1973 from Clerk of United States Court of Appeals for the Fifth Circuit Correcting Opinion Issued in *Placid Oil Company, et al.* v. *Federal Power Commission,* Nos. 71-2761, *et al.*	62
APPENDIX D:	Natural Gas Act, Sections 4, 5, and 19(b)	65

Note: Federal Power Commission Opinion Nos. 598 and 598-A are reproduced at pages 559 and 865, respectively, of Part I, Volume 2 of the Joint Appendix, as prepared for the lower court. Copies of Part I, Volume 2 have been filed with the Clerk of the Supreme Court in conjunction with these Appendices to the Petition for Writ of Certiorari.

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

OCTOBER TERM, 1971

No. 71-2761

Your No. AR 61-2

PLACID OIL COMPANY, ET AL.,
Petitioner,

versus

FEDERAL POWER COMMISSION,
Respondent.

On Petition to Review and Set Aside Opinions and Orders of the Federal Power Commission

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Before BROWN, Chief Judge, BELL and MORGAN, Circuit Judges.

JUDGMENT

This cause came on to be heard on the petition of Placid Oil Company, Et Al for review of orders of the Federal Power Commission of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the petition for

review of orders of the Federal Power Commission in this cause be, and the same is hereby enforced;

It is further ordered that petitioners pay to intervenors-respondents the costs on appeal to be taxed by the Clerk of this Court.

April 16, 1973

Issued as Mandate: Jun. 19, 1973.

A true copy

Test:

EDWARD W. WADSWORTH
Clerk
U. S. Court of Appeals
Fifth Circuit

By /s/ Maryette K. Farley
Deputy
Jun. 19, 1973
New Orleans, Louisiana

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 71-2761

PLACID OIL COMPANY, ET AL., (SoLa II)
Petitioners,

versus

FEDERAL POWER COMMISSION,
Respondent.

On Petition to Review and Set Aside Opinions and Orders of the Federal Power Commission

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ON PETITIONS FOR REHEARING

(June 11, 1973)

Before BROWN, Chief Judge, BELL and MORGAN, Circuit Judges.

PER CURIAM: Of the 49 various parties and intervenors who entered formal appearances in this case, only two—Mobil and Amoco—have petitioned the Court for rehearing.

Both of these parties contest our statement that "no party [20] directly challenges this [new gas] rate as being

too low." [Slip Opinion at p. 36]. On reconsideration, we believe that the statement might be somewhat misleading. Accordingly, it shall be deleted from the opinion and the following sentence shall be inserted in its place: "Of all the various parties[20] and interests represented in this case, only Mobil and Amoco suggest that this rate is too low."

In all other respects, IT IS ORDERED that the petitions for rehearing filed in the above entitled and numbered cause be and the same are hereby DENIED.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 71-2761

PLACID OIL COMPANY, ET AL.,
Petitioners,

versus

FEDERAL POWER COMMISSION,
Respondent.

On Petition to Review and Set Aside Opinions and Orders of the Federal Power Commission

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(April 16, 1973)

Before BROWN, Chief Judge, BELL and MORGAN, Circuit Judges.

BROWN, Chief Judge: Today we must decide if what FPC has said—in response to what we said about what FPC said about what the Supreme Court said—is supported by "substantial evidence on the record as a whole". In short, we must review FPC Op: 598 which undertakes to establish the "just and reasonable" rates at which natural gas producers may sell gas in the Southern Louisiana Area (SLA). This followed in the footsteps of our *Austral Oil Co.* v. *FPC*, 5 Cir., 1970, 428 F.2d

407, which we now denominate as *SoLa I* in the almost certain assurance that what we write today will be known far and wide as *SoLa II*, and with the hope—for which there is no such assurance—that there will be no *SoLa III*, or *IV*, or *V*.

I. *Area Rate Regulation in Perspective*

Nearly twenty years have elapsed since the Supreme Court, in *Phillips I*,[1] first held that it was incumbent upon FPC to regulate the well-head sales by producers of natural gas to interstate pipelines. For six years FPC wandered frantically in its attempt to regulate each producer individually. Realizing that its resources were being exhausted more rapidly than the gas under scrutiny with little to show for it, FPC, in *Phillips II*,[2] decided to abandon the individual producer method of rate regulation and to invoke its rule-making powers to establish area-wide rate ceilings for the industry as a whole. Accordingly, it established seven geographically identifiable producing areas and commenced its formidable task.[3]

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[1] Phillips Petroleum Co. v. Wisconsin, 1954, 347 U.S. 672, 74 S.Ct. 794, 98 L.Ed. 1035 *(Phillips I)*.

[2] See Wisconsin v. FPC, 1963, 373 U.S. 294, 83 S.Ct. 1266, 10 L.ed.2d *(Phillips II)*.

[3] FPC has now completed its proceedings for six of the seven areas. The status of these proceedings are as follows:

(1) *Southern Louisiana Area.* The first SLA Rate Case *(SoLa I)* culminated with Op: 546, affirmed on review, SLA Rate Cases (Austral Oil Co.) v. FPC, 5 Cir., 1970, 428 F.2d 407, *on rehearing*, 1970, 444 F.2d 125, *cert. denied sub nom.*, 1970, 400 U.S. 950, 91 S.Ct. 241, 27 L.Ed.2d 257. The provisions of Op: 546 were superseded, however, by Op: 598. This Opinion and the resulting order are the subject of this Appeal.

(2) *Permian Basin Area.* FPC's rate regulations for this area were sustained by the Supreme Court in Permian Basin Area Rate Cases, 1968, 390 U.S. 747, 88 S.Ct. 1344, 20 L.Ed. 2d 312. FPC has continued its efforts for this area in a subsequent round.

[Footnote continued on page 7]

The first efforts of FPC to establish rates for the SLA reached fruition in Op: 546. After an extensive review in this Court, we decided—largely because of the fact

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[8] [Continued]

Permian II, FPC docket no. AR 70-1, 45 F.P.C. 192 (1971), is now awaiting an initial decision by the Administrative Law Judge.

(3) *Hugoton-Anadarko Area.* Op: 586 promulgating rate ceilings for this area was recently sustained by the Ninth Circuit. Hugoton-Anadarko Area Rate Case: California v. FPC, 9 Cir., 1972, 466 F.2d 974.

(4) *Texas Gulf Coast Area.* Op: 595 now pending review in D. C. Circuit.

(5) *Other Southwest Area.* Op: 607 now pending review in Fifth Circuit. Docket No. 72-1114, Argued March 27, 1973.

(6) *Appalachian and Illinois Basin Area.* Op: 639 now pending review in Fifth Circuit.

(7) *Rocky Mountain Area.* Proceedings to establish maximum permissible rates for the seventh producing area are currently underway in FPC docket no R-425. See Phillips Petroleum Co. v. FPC, 10 Cir., 1973, —— F.2d ——, [No. 71-1659, February 20, 1973.]

In addition to its rule-making powers under § 5 and 16 of the Natural Gas Act, FPC has also wielded its certificating powers under § 7 to keep the prices "in line" pending resolution of the area rate cases. See CATCO (Atlantic Refining Co. v. Public Service Commission of New York), 1959, 360 U.S. 378, 79 S.Ct. 1246, 3 L.Ed.2d 1312; United Gas Improvement Co. v. Callery Properties, 1965, 382 U.S. 223, 86 S.Ct. 360, 15 L.Ed.2d 284; FPC v. Sunray DX Oil Co., 1968, 391 U.S. 9, 88 S.Ct. 1526, 20 L.Ed.2d 388. The exact relationship between its § 5 rules and its § 7 rules is, as yet, largely undecided. It does appear, however, that FPC will use both powers in a complementary manner to achieve its objectives of eliciting an additional supply and establishing greater rate stability. See FPC order No. 455, "Statement of Policy Relating to Optional Procedure for Certificating New Producer Sales of Natural Gas", 18 C.F.R. § 2.75 (August 3, 1972). Subsequent to the printing of this opinion the Court became aware that Op: 658 partially setting rates for the Rocky Mountain Area was issued on April 11, 1973. FPC has apparently also decided to issue national rates which pre-empt these area determinations under its rule-making power in its Docket No. R-389B. See Foster Associates Report No. 891 (April 12, 1973).

that area rates were an "experiment" for FPC, and in spite of our very serious reservations about the adequacy of FPC's conclusions (particularly its failure to assess the probable consequences of its action in terms of supply and demand)—to affirm Op: 546. *SoLa I:* 428 F.2d 407. But our opinion on rehearing, 1970, 444 F.2d 125, *cert. denied sub. nom.* 1970, 400 U.S. 950, 91 S.Ct. 241, 27 L.Ed.2d 257, was very significant. Charting the parameters of that decision is therefore a prerequisite to effective review of this case. For we must determine whether, as FPC would have us believe, what we said must happen is really what we got.

II. *Mandate of SoLa I*

Op: 546, reviewed by this Court in *SoLa I*, followed the *Permian*-approved method of a multi-tiered rate structure. Thus, the permissible rate varied from 17.0¢ Mcf to 20.0¢/Mcf,[4] depending, as with wine, on the vin-

[4] The Court described the Op: 546 rate structure:

"(1) The Rate Structure

The Commission repeated in Southern Louisiana the multiple rate structure it had introduced in *Permian*, this time settling three different price levels for what it denominated as first, second, and third vintage gas. For first vintage gas, that for which contracts of interstate sale had been made prior to 1961, the Commission set a ceiling of 18.5 cents per thousand cubic feet (Mcf). For second vintage gas, that contracted for between the dates of January 1, 1961, and October 1, 1968, it set a ceiling of 19.5 cents. For third vintage gas, that contracted for after October 1, 1968, it set a ceiling of 20 cents. For offshore gas in the federal domain, which is not subject to the Louisiana severance tax, it set prices for each of the three vintages 1.5 cents below onshore levels. For casinghead gas (gas produced in association with oil), the Commission set prices equal to those of first vintage gas irrespective of the vintage. The Commission found that casinghead gas is discovered largely as a by-product of the search for oil and exploration for it thus could not be encouraged by the higher prices of second and third vintage gas.

[Footnote continued on page 9]

tage of the gas—the only difference being that the newer, or newest, gas was the most dear. The theory behind this multi-tiered system was that a greater price had to be allowed for new gas. This was because its cost had to include an increment to account for the need for committing new reserves to the interstate market, and also because in the economic situation of the day, gas had achieved a greater value than before. Thus, in determining the cost per Mcf, the flowing gas costs were determined from historical data for SLA. The theory was that the rate ceilings should be adjusted to allow for re-

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[4] [Continued]

"The price structure thus established is summarized in the following chart."

Vintage or Type	*Onshore Price*	*Offshore Price*
First vintage	18.5 cents	17.0 cents
Second Vintage	19.5 cents	18.0 cents
Third Vintage	20.0 cents	18.5 cents
Casinghead	18.5 cents	17.0 cents

SoLa I:419

The unit cost used to establish these rates was as follows:

Item	*New Gas*	*Flowing Gas*
Exploration and Development	4.14	4.17
Production Operating Expense	2.70	1.93
Liquid Credit	(3.30)	——
Depletion, Depreciation, Amortization	4.04	3.19
Return on Investment	5.33	5.17
Return on Working Capital	0.35	——
Regulatory Expense	0.15	0.17
Royalty	2.24	——
Area Gathering	0.51	0.51
Production Tax	2.30	2.30
TOTAL	18.80	18.36

All figures given are unit costs, in cents per Mcf. The grouping of flow gas costs is different from that for new gas; the flowing gas E & D computation, for example, contains some allowance for rate of return.

SoLa I: 420 n.23

coupment of these costs. The costs for new gas, on the other hand, were based upon nationwide data and a 12% rate of return. To insure rate stability in the immediate future FPC ordered a five year moratorium on increased rate filings above the rate set by Op: 546. FPC also ordered substantial refunds.[5]

Op: 546 was challenged by both consumer and producer interests. Nearly every feature of the plan was assaulted. Except for its statutory advocate, the general counsel, scarcely a good word was said of Op: 546. The battle raged over two claims. The consumer interests argued that FPC had unlawfully padded the rate with non-cost items. On the other hand, the counter-contention of the producers was that FPC had failed to adequately take account of the severe shortage in the supply of natural gas reserves and the importance of price when it established the rates. As to non-cost factors which are clearly labeled and justified, we held that they may be used to further the overall purposes of the regulatory undertaking:

> Non-cost factors may be used to influence market variables such as supply and demand, to create price stability, to influence industry structure, to simplify a rate schedule, and for many other purposes, but only if they are clearly identified and explained.

SoLa I: 441

As to the acute shortage of gas, we expressed great disappointment that FPC had failed to consider the proposed rates in terms of the effect which they might have

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[5] The refund obligations were calculated on the basis of the difference between the first and second vintage rates established by Op: 546 and the actual rates collected by the producers subject to refund. They totaled approximately $375,000,000 for the entire SLA.

A system of quality adjustments and special exemptions was also established by FPC. See *SoLa I:* 421 n.25.

on our nation's supply of natural gas. This inescapably is a matter of gas reserves. Realizing that FPC might want to rectify this omission in its future consideration of the appropriate rates for SLA, we took careful pains, especially in the opinion on rehearing, to make sure that our affirmance of the Op: 546 rate structure would not impair FPC's authority to formulate a more flexible plan if the need arose. *SoLa I:* 444 F.2d 125.

Of course, *SoLa I* was also very instructive as an indication of the standard of review which this Court should, in the post-*Permian* era, employ in reviewing rate determinations by FPC. Realizing that "FPC must evaluate each rate set against policies as broad as the Natural Gas Act itself," *SoLa I:* 435, and that area rate regulation was still in the "experimental" stage, we continued the very flexible, but realistic, standard established by *Permian*:

> The *Permian* decision thus indicates that a reviewing court must look to both individual components and over-all effect of rates set by the Commission, but that the Commission has broad discretion that is not to be ineffectuated by either theoretical disagreement with its methods or by discovery of inadequacies that are caused mainly by the difficulty of the regulatory undertaking. The Commission is to be affirmed if it has followed the correct legal standards and acted on the basis of substantial evidence, and under any fair interpretation of *Permian* it appears that the legal standards themselves are to be construed liberally when applied to a regulatory effort still in the experimental stage. This "experiment" doctrine, together with the substantial evidence rule, is background for our consideration of most of the issues presented on this appeal.

Sola I: 418

The steps which a reviewing court must take had been quantified with even greater particularity by *Permian* itself:

"Section 19(b) of the Natural Gas Act provides without qualification that the "finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive." More important, we have heretofore emphasized that Congress has entrusted the regulation of the natural gas industry to the informed judgment of the Commission, and not to the preferences of reviewing courts. A presumption of validity therefore attaches to each exercise of the Commission's expertise, and those who would overturn the Commission's judgment undertake "the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences." FPC v. Hope Natural Gas Co., supra, at 602, 88 L.Ed. at 345. We are not obliged to examine each detail of the Commission's decision; if the "total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." Ibid.

Moreover, this Court has often acknowledged that the Commission is not required by the Constitution or the Natural Gas Act to adopt as just and reasonable any particular rate level; rather, courts are without authority to set aside any rate selected by the Commission which is within a "zone of reasonableness." FPC v. Natural Gas Pipeline Co., 315 US 575, 585, 86 L.Ed. 1037, 1049, 62 S.Ct. 736. No other rule would be consonant with the broad responsibilities given to the Commission by Congress; it must be free, within the limitations imposed by pertinent constitutional and statutory commands, to devise methods of regulation capable of equitably reconciling diverse and conflicting interests.

The Permian Basin Area Rate Cases, 1968, 390 U.S. 747, 767, 88 S.Ct. 1344, ——, 20 L.Ed.2d 312, 336.*

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*The four elements which delineate the scope of a reviewing court's authority, thus presented, are as follows: (i) the well-known statutory "substantial evidence" standard, (ii) a judicially recognized "presumption of validity" implied from the congressional

Does the "experiment" rationale of *Permian* and *SoLa I* still warrant a kid glove review of FPC rate cases? We think that it does. Cast in the perspective of the human travail, some might say that the dozen year experience with area rate regulation should arguably justify a holding that the experimental phase has passed. In 1971, when Op: 598 was written, however, FPC had only twice been the beneficiary of the judicial function to declare "what the law is". No one can honestly say that judges have been any more sure than commissioners, as all struggle with a problem that grows out of the peculiar mixture of a simultaneous service and exhaustion of a depletable asset. All have been groping. The day for groping is not yet over. And it does not denigrate what FPC has done to say that much may yet be imperfect and much remains to be done or redone. So we can find that FPC has conscientiously attempted

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limitation, (iii) the long-standing "total effect" test of FPC v. Hope Natural Gas Co., 1944, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333, and (iv) a "zone of reasonableness" to compensate for the necessarily imprecise nature of cost determinations and the inherent difficulty of the regulatory undertaking. Having thus prescribed the extent of its powers, *Permian* proceeded to outline the breadth of its duty:

> It follows that the responsibilities of a reviewing court are essentially three. First, it must determine whether the Commission's order, viewed in light of the relevant facts that of the Commission's broad regulatory duties, abused or exceeded its authority. Second, the court must examine the manner in which the Commission has employed the methods of regulation which it has itself selected, and must decide whether each of the order's essential elements is supported by substantial evidence. Third, the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable. The court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors.

Permian, supra at 791-92, 88 S.Ct. at ——, 20 L.Ed.2d at 350.

to establish "just and reasonable" rates within the framework allowed by judicial precedent, yet, it is still experimenting.

FPC has approached the polycentric problem of area rate regulation with commendable flexibility. But its efforts are perforce an experiment. To those who deplore this lack of certitude, it is worth remembering that we have seen the Fourth, Fifth, and Sixth and Fourteenth Amendments come alive in the short span of a couple of decades.

But we emphasize that we will not allow the kid glove to hold a rubber stamp. One of the basic holdings in *SoLa I* was that non-cost factors are, or may be, a proper element of rate structure if they are clearly labeled and justified on the basis of "substantial evidence on the record as a whole". They may not be used, however, as thumbs-on-the-scale to compensate for inaccurate calculations. In *SoLa I*, we cautioned:

> "The gas industry * * * requires a constant infusion of entrepreneurship of the highest order if even basic public needs are to be satisfied * * * we count upon persons who carefully weight investment risks for our supply of natural gas. We think the Commission here, having calculated the dangers involved in allowing the gas supply to lapse, and the probabilities that its estimates might be too low, is justified in having added the small non-cost factors it thought were necessary. It found that it needed to do so to protect the public interest and not to assume any rights of gas producers. However, * * * the use of non-cost factors to allow for possible inaccuracies is not favored. Inaccuracy, if that is *really* the concern (and not higher costs), can result in a windfall to producers as easily as in a loss. We approve the use of non-cost factors for this purpose under the facts of this case only."

SoLa I: 426 n.46

Of course, this is not to suggest that we hold FPC to any certain degree of mathematical accuracy. "There is nothing in the substantial evidence rule that prevents the Commission from performing calculations based upon necessarily imperfect assumptions when it explains the reasons for those assumptions. Likewise, there is nothing to prevent it from re-examining and adjusting the result of a calculation based upon imperfect premises, provided it justifies its actions on the basis of the record." *SoLa I:* 423. Indeed, we share Judge Breitenstein's distaste for the vagaries of rate calculations as he struggled for a beleaguered Tenth Circuit in *Permian*:

> "The assumptions, allocations, formulae, equations, averages, means, and massive calculations may intrigue a mathematician or statistician but they have no attraction for us. We respectfully decline to be drawn into such a turmoil of numbers. We cannot in a few months unravel the snarl of statistics developed in the years of hearings. In our opinion, the judicial process, in cases such as this, should be confined to consideration of errors of law. We leave to the experts the selections of source material and the calculations to be made therefrom. Our concern is with the result."

Skelly Oil Co. v. *FPC*, 10 Cir. 1967, 375 F.2d 6, 24, *aff'd.*, The Permian Basin Area Rate Cases, 1968, 390 U.S. 747, 88 S. Ct. 1344, 20 L.Ed.2d 312.

III. Opinion 598

Coincident with its issuance of Op: 546, reviewed by this Court in *SoLa I*, FPC began a second round of rate procedings for SLA to update, as might be appropriate, developments since the close of that then very stale record. On this basis, taking the admonishments of this Court[7] to heart and its authority[8] to hand, FPC after

[7] SoLa I: 428 F.2d 407.

[8] Se SoLa I: 444 F.2d 125 (on rehearing).

the affirmance of *SoLa I* reopened its consideration of the "just and reasonable" rates for all gas produced in SLA past, present, and future. By administrative order, FPC consolidated the revived *SoLa I* proceeding with the new *SoLa II* proceeding and brought forward the entire record. But it did not stop there. During the course of subsequent hearings before the Examiner, whose position has now been elevated to Administrative Law Judge, a total of 7831 pages (57 volumes) of testimony was heard from 59 witnesses and 111 new exhibits were received into evidence. And yet, with these countless words, charts, diagrams, opinions, projections and estimates, we are told that the record is inadequate! But whatever its deficiencies, with this expansive record before it, FPC then adopted, via Op: 598, the rate structure presented in a proposed settlement agreement.

As it strived to bring its tortuous odyssey of ratemaking in SLA to an end, FPC fixed its course for the public weal. Realizing that the stimulation of private entrepreneurs to develop SLA's most precious resource would be a difficult task, FPC determined at the outset, not only to use a flexible approach, but also to jettison the formalistic, legalistic, unworkable rigidity of a typical utility basis:

> 11. Our duty is to take all the action we believe necessary to reverse a downtrend of the exploration and development effort, thereby to increase the likelihood of augmenting the national inventory of proved reserves of natural gas. We would be derelict—we can think of no softer word—if we were to be guided by the legalisms of the past in seeking solutions to the problems which have grown like barnacles as this case has aged and its size has mounted. As far as we are concerned, in the prescription of just and reasonable rates, Opinion Nos. 546 and 546-A now perform no office.

Op: 598, ¶ 11.

FPC adopted a total rate structure to motivate private producers to fully develop SLA's resources. The trifaceted incentive program established by FPC in Op: 598 has been likened by Amoco to a three-legged stool. At the onset the rates themselves were adjusted upward from the *SoLa I* figures. Then, a stipulated refund obligation which was significantly lower than that imposed in *SoLa I* and a program to work-off the refund obligations by committing additional new reserves to interstate sales was implemented. Finally, automatic periodic escalations and further escalations contingent upon the dedication of new reserves to the jurisdictional market were adopted. In synthesis, it looks like this:

a. *Ceiling Prices.* The following ceiling prices are prescribed:

(1) For Contracts Dated Prior to October 1, 1968:

Onshore	22.375¢
Offshore	21.375¢

(2) For Contracts Dated On or After October 1, 1968:

Onshore	26.0¢
Offshore	26.0¢

b. *Periodic Escalations of Ceiling Prices.* The ceiling prices applicable to contracts dated prior to October 1, 1968, shall escalate by one-half cent (0.5¢) per Mcf on October 1, 1973.

The ceiling prices applicable to contracts dated on or after October 1, 1968, shall escalate by one cent (1.0¢) per Mcf on October 1, 1974.

c. *Contingent Escalation of Ceiling Prices.* [For gas under contracts dated prior to October 1, 1968] when new gas reserves dedicated to the interstate market total 7½ trillion cubic feet of gas reserves in the Southern Louisiana area prior to October 1,

1977, the ceiling prices then in effect shall be increased by one-half cent (0.5¢) per Mcf.

Further successive increases of one-half cent (0.5¢) per Mcf in the ceiling prices shall be made when a total of 11¼ trillion cubic feet of new gas reserves have been committed to jurisdictional sales prior to October 1, 1977, and again when 15 trillion cubic feet of such new gas reserves have been committed to jurisdictional sales prior to October 1, 1977.

d. *Refunds.* Refunds in the total amount of $150,000,000 shall be made provided that any company having a refund obligation may reduce such obligation by one cent (1.0¢) for each Mcf of new gas reserves committed to a jurisdictional market in Southern Louisiana. Any new gas reserves used for the purposes of reducing refund obligations shall not apply in computing the contingent escalations prescribed above.

Amoco's chief objection is that it does not receive an equal portion of all three legs. We deal with this contention in great detail, *infra*, but for metaphorical integrity we must say at this point that every producer, including Amoco, benefits from at least two of these incentives. Under the Natural Gas Act, FPC has done its job, and done it well, if the rate structure which it adopts allows every producer of natural gas in SLA to stand on his own two legs!

Op: 598 employed the *Permian*-approved, multi-tiered vintage rate structure. But whereas FPC had established three "vintages" of rates in Op: 546, in Op: 598 it simplified the approach to a two-tiered structure. Under the new structure, "flowing" or "old" gas* may be

* Actually, it is a misnomer to speak of "old" gas. The maximum permissible rate is contingent upon the date of the contract for the sale of the gas. Under the terms of Op: 598, gas contracted for prior to October 1, 1968, is subject to the above ceilings. Of course, given the fungible nature of gas and the fact that a quantity of gas

sold for 22.375¢/Mcf (onshore) or 21.375¢/Mcf (offshore). This increase in rate, hotly contested on this appeal, was coupled with the automatic and contingent escalations and a decrease in the amount of refunds from approximately $375,000,000 to a stipulated $150,000,000.[10]

Based upon its self-professed inexact calculation of the cost (including a projected rate of return of 15%) which we discuss in much greater detail *infra*, FPC determined that the maximum permissible price for all new gas, i.e., gas committed under the terms of a post-October 1, 1968 contract—whether produced on or off shore[11]—was 26¢/Mcf.

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is rarely—if ever—severed and identified for a particular contract, the quantitative demands of the old contracts may be satisfied from a supply reaped from a 1972 well just as easily as from a pre-1968 well. Actually, then, the first vintage rates established by Op: 598 are those maximum rates which may be charged for either old or new gas delivered under the terms of an *old gas contract*.

Perhaps it would be possible to make a more exact allocation of expenses, particularly for exploration and development, if the changes in rates varied—not according to the date of the contract—but rather according to the date on which the well was drilled or the gas was pumped. But that is an administrative, not a judicial, decision. Under our limited scope of review, we must confine our inquiry to the question of whether the choices made by FPC are supported by "substantial evidence on the record as a whole." Recognizing this limitation upon our duty and authority, we will scrutinize the various rates on the basis of their success *vel non* in accomplishing the desired end result of the regulatory process.

[10] Op: 546, FPC had established three "vintages" of gas. The ceiling price for gas committed under a pre-1961 contract was 18.5¢/Mcf (onshore) or 17.0¢/Mcf (offshore), and the ceiling price for gas committed under a contract signed between January 1, 1961, and October 1, 1968, was 19.5¢/Mcf (onshore) or 18.0¢/Mcf (offshore). All post-October 1, 1968 or "new" gas was subject to a third vintage rate of 20.0¢/Mcf (onshore) or 18.5¢/Mcf (offshore). In *SoLa II*, FPC decided to make only one vintage rate for all pre-October 1, 1968, or "flowing" gas.

[11] Under the *SoLa I* rate scheme there was a 1.5¢/Mcf disparity between the price of onshore and offshore gas. The higher price is allowed for onshore gas to permit the producer to pay the state

The Propriety of Adopting a Proposed Settlement Agreement

The rate structure finally approved by FPC in Op: 598 actually originated as a proposed settlement agreement. It was offered as such by UDC, a consumer oriented group of distributors. Although the lack of unanimity of support from some of the various parties precluded the possibility of its functioning as a settlement in the traditional sense, FPC adopted it as a decision on the merits.

No one seriously doubts the power—indeed, the duty—of FPC to consider the terms of a proposed settlement which fails to receive unanimous support as a decision on the merits. We agree with the D.C. Circuit that even "assuming that under the Commission's rules [a party's] rejection of the settlement rendered the proposal ineffective *as a settlement*, it could not, and we believe should not, have precluded the Commission from considering the proposal *on its merits*." *Michigan Consolidated Gas Co.* v. *FPC*, D.C. Cir., 1960, 283 F.2d 204, 224, *Cert. denied sub. nom. Panhandle Eastern Pipe Line Co.* v. *Michigan Consolidated Gas Co.*, 1960, 364 U.S. 913, 81 S.Ct. 276, 5 L.Ed.2d 227. Cf. *Pennsylvania Gas & Water Co.* v. *FPC*, D.C. Cir., 1972, 463 F.2d 1242; *Amoco Production Co.* v. *FPC*, 10 Cir., 1972, 465 F.2d 1350; *Cities of Lexington, Ky.* v. *FPC*, 4 Cir., 1961, 295 F.2d 109. If there was ever an area in contemporary socio-economic problems in which the snail-like pace of a transplanted Article III Case and Controversy is inadequate, this endless struggle for sloution through the proliferation of administra-

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of Louisiana 2.3¢/Mcf severance tax. Because the 1.5¢/Mcf difference under Op: 546 did not exactly correlate to the amount of the tax, several petitioners suggested that there was a .8¢/Mcf "phantom" tax. Recognizing that several other factors might materially affect the cost of offshore production and warrant a greater per unit rate absent the tax, we categorically rejected this notion in *SoLa I:* 425 n.43.

tive orders and judiciary appeals is surely it. Ironically, while Rome burns, the gas has gone out. If—and the *IF* gets bigger every day—the country is to solve this problem, it has to be done by adjustment, compromise, give and take. FPC settlements are therefore to be encouraged.

FPC was conscious of its role. It specifically held that the proposal's "wide support helps to provide stability in prices in the area and relieve the administrative burden of the Commission, and to reduce the probabilities of future litigation." Op: 598 ¶ 39. Certainly consumers were involved. UDC is a coalition of 32 major distribution companies representing approximately 25% of the gas distribution in the United States and serving about 10.3 million customers at retail.[12] The proposal was also supported by Associated Gas Distributors (AGD), *all* interstate pipelines purchasing gas from SLA, and 46 natural gas producers comprising 80% of the total gas production in the area. Obviously, this broad base of support was an important consideration for FPC.

The objectivity of the settlement proposal comes not only from its advocates but also from its opponents. The proposal was, and is, stridently opposed by two very much aggrieved producers, Amoco and Mobil, and two consumer champions, The Municipal Distributors Group (MDG) and the highly vocal New York Public Service Commission (NYPSC). The presence of such vigorous combatants gives some assurance that the proposal could not have been accepted without consideration, both pro and con, of all sides of the problem.

As it should, FPC is employing its settlement power under the APA, 5 U.S.C.A. § 554(c), and its own rules 18 C.F.R. § 1.18(a), to further the resolution of area

[12] Following our initial classification, see *SoLa I:* 434 n.86, FPC cast UDC as consumer advocates.

rate proceedings. If a proposal enjoys unanimous support from all of the immediate parties, it could certainly be adopted as a settlement agreement if approved in the general interest of the public. But even if there is a lack of unanimity, it may be adopted as a resolution *on the merits*, if FPC makes an independent finding supported by "substantial evidence on the record as a whole" that the proposal will establish "just and reasonable" rates for the area. In short, there is no virtue in the end result having come from judicial-like conception, gestation and the supposed agonies of deliverance. What the nation needs is gas, that is, gas that is burnable.

As it did in Op: 598, FPC also adopted the terms of a proposed settlement as its decision on the merits of the Hugoton-Anadarko Area Rate Case, Op: 586, *aff'd*, 9 Cir., 1972, 466 F.2d 974. The Ninth Circuit, taking specific notice of the fact that the proposal was adopted on its intrinsic merits rather than as a traditional settlement *per se*, heartily endorsed the procedure. We called for supplemental briefs to determine the relevance of that case to this. Both FPC and UDC suggest that *Hugoton-Anadarko* is controlling. Indeed, they suggest that FPC's adoption of the proposal for SLA is even more appropriate than *Hugoton-Anadarko* because (i) the parties in *SoLa II* were given an opportunity to rebut the proposal with additional evidence, (ii) the *SoLa II* proposal, unlike that for *Hugoton-Anadarko* clearly specified the rate of return under which the rates were established, and (iii) the *SoLa II* proposal enjoys substantial support from consumers as well as producers interests. Mobil, on the other hand, informs us that it, along with *all* of the other producers in *Hugoton-Anadarko* supported *that* proposal. We find this to be a distinction without merit. In both cases the proposals were adopted—not as settlements—but rather as resolutions on the merits. Hence, we believe that the presence of support by both consumers

and producers yields a greater likelihood of acceptability by FPC than does the unanimous support of all producers.

NYPSC raises a more serious objection to FPC's adoption of the settlement proposal. It objects to the apparent "all or nothing" approach which FPC took toward the proposal. As a topical preface this brings us to the fundamental question—whether, viewing the terms of the proposal not as a traditional settlement but as a result of an administrative decision, it falls within that "zone of reasonableness" which is supported by "substantial evidence on the record as a whole". It is upon this question that we must focus our attention in the context of this case. Consequently, we consider the evidence and evaluate the FPC sanctioned settlement proposal in that context.

IV. No Gas. What Do We Do?

> "The heart of this problem is the elusive, exhaustible, and irreplaceable nature of natural gas itself. Given sufficient money, we can produce any desired amount of railroad, bus, or steamship transportation. * * * But the wealth of Midas and the wit of man cannot produce or reproduce a natural gas field."

FPC v. Hope Natural Gas Co., 1944, 320 U.S. 591, 629, 64 S.Ct. 281, ——, 88 L.Ed. 333, 359 (Jackson, J. dissenting.)

We may not as judges ignore what all others see. And certainly we cannot ignore what the agency charged by Congress with protecting, not the price of gas at the Brooklyn burner tip, but the *supply* of gas to meet that and other needs, has found. Led by FPC, all others in the nation sense with a desparate urgency an energy supply shortage which can only be described as a crisis.[13]

[13] As might be expected, there is some controversy over this. Standing virtually alone against the National (and record) judg-

Spurred by the efficiency of gas as an energy source, the attractiveness of natural gas rates as compared with those for other energy sources, and most recently by a belated but vigorous national clamor for an ecologically beneficial energy source, American consumption of natural gas for industrial, commercial, and private consumer use is rapidly expanding. This proliferating demand has already outstripped a dwindling supply.[14] Thus, there is an increasing gap between supply and demand, and the consumers are feeling, or shortly will feel, the pinch. See e.g. *International Paper Co.* v. *FPC*, 5 Cir., 1973, —— F.2d —— [71-3531]; *FPC* v. *Louisiana Power & Light Co.*, 1972, 406 U.S. 621, 92 S.Ct. 1827, 32, L.Ed.2d 369; The *Hugoton-Anadarko* Area Rate Case, 9 Cir., 1972,

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ment of a near energy calamity, the American Public Gas Association (APGA) contends that the current critical shortage of natural gas is but a pretextual "cry of wolf" calculated to mislead FPC into establishing artificially high rates in the producers' behalf. APGA would have us believe that the energy crisis is a mirage—indeed, a hoax! APGA claims that "there appear to be adequate supplies of gas in the domestic United States to satisfy the projected demands of U. S. consumers well into the 21st Century." APGA Supp. Brf. at 5 n.9. But to talk of "supplies" of gas is a misleading oversimplification. Obviously, the gas is not presently available. At most, if there is appropriate exploration, the demonstrable reserves may be exploited to meet the needs. Given a system which depends on private stewardship and marshalling of natural resources, there is a supply shortage if the producers do not produce. FPC has the statutory duty, not only to guard the consumers against super-profits reaped from artificially inflated rates, but also to protect consumer interests by making sure that the rate schedule is high enough to elicit an adequate supply. It is a delicate balancing test. FPC must fix its course to attain the utopian "optimum" rate schedule. Given the current shortage of available supply FPC must swing the pendulum towards the incentive, supply-eliciting side of rates. And so it has done.

[14] Staff Report No. 2, which chronicles the supply and demand patterns of the past and projects the picture for the period 1971-1990 reveals that in 1971, for the first time ever, available supply failed to meet actual demand. In that year there was .9 Tcf of unsatisfied demand. As the following table and chart reveals, Staff projects more drastic shortages in the future:

Table 1

UNITED STATES GAS SUPPLY-DEMAND BALANCE

Actual 1966-1970; Projected 1971-1990

(All Volumes in Trillions of Cubic Feet @ 14.73 Psia and 60° Fahrenheit)

Year	Annual Demand [1]	Net Pipeline Imports	LNG Imports	Gas From Coal	Gas From Alaska	Gas From Liquid Hydrocarbons	Domestic Production	Annual Consumption	Unsatisfied Demand	Reserve Additions	Year-end Reserves	R/P Ratio
1966	17.9	0.4	—	—	—	—	17.5	17.9	0.0	19.2	286.4	16.4
1967	18.8	0.5	—	—	—	—	18.4	18.8	0.0	21.1	289.3	15.8
1968	19.9	0.6	*	—	—	—	19.3	19.9	0.0	12.0	282.1	14.6
1969	21.3	0.7	*	—	—	—	20.6	21.3	0.0	8.3	269.9	13.1
1970	22.6	0.8	*	—	—	—	21.8	22.6	0.0	11.1	259.6	11.9
1971	24.6	0.9	*	—	—	—	22.8	23.7	0.9	12.0	248.8	10.9
1972	26.1	1.0	*	—	—	**	23.8	24.8	1.3	13.0	238.0	10.0
1973	27.7	1.1	*	—	—	**	24.7	25.8	1.9	14.0	227.3	9.2
1974	28.8	1.1	*	—	—	**	24.8	25.9	2.9	15.0	217.4	8.8
1975	29.8	1.2	0.3	—	—	**	24.7	26.2	3.6	16.0	208.7	8.4
1980	34.5	1.6	2.0	0.3	0.7	**	20.4	25.0	9.5	17.0	186.1	9.1
1985	39.8	1.9	3.0	1.4	1.3	**	18.5	26.1	13.7	17.0	175.4	9.5
1990	46.4	1.9	4.0	3.3	2.3	**	17.8	29.3	17.1	17.0	170.4	9.6
1971-1990 Totals	707.6	31.1	38.0	17.3	20.6	**	414.2	521.2	186.4	325.0	—	—

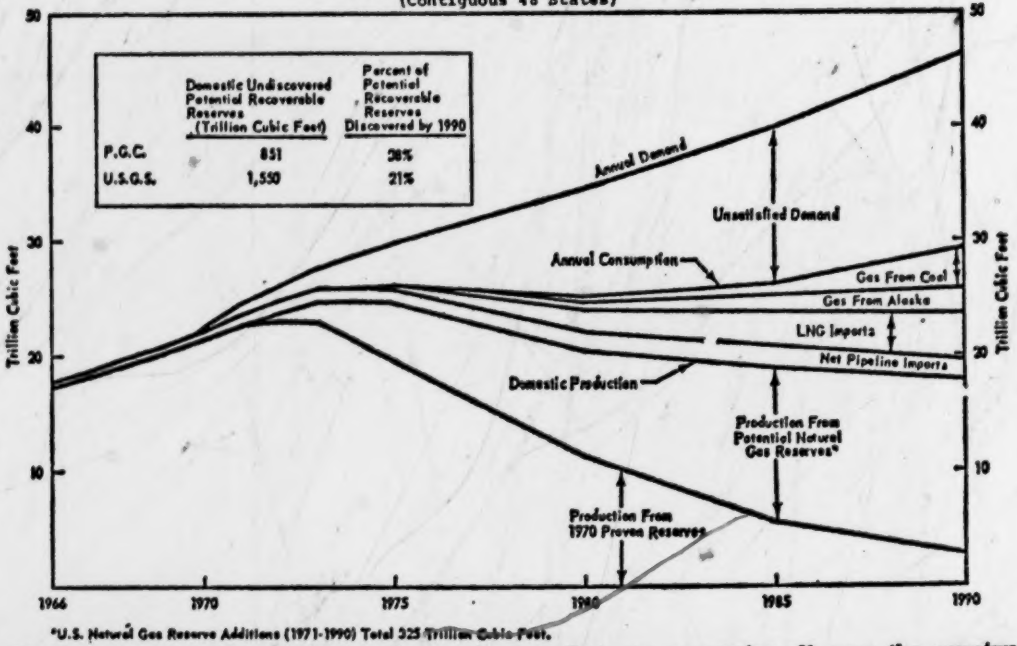
* Very small volumes

** Insufficient data for quantitative projection: unsatisfied demand will be reduced by the amount of SNG actually produced.

[1] Contiguous 48 states.

Figure 1

UNITED STATES GAS SUPPLY-DEMAND BALANCE
(Contiguous 48 States)



*U.S. Natural Gas Reserve Additions (1971-1990) Total 325 Trillion Cubic Feet.

Of Course we can take judicial notice of the fact that gas companies all over the country are having to curtail the service to their customers.

466 F.2d 974; *City of Chicago* v. *FPC*, D.C. Cir., 1971, 458 F.2d 731, 747-49. Finger-pointing accomplishes nothing, for there is no single isolated factor which has contributed to this shortage. History may well record this near crisis as just another of man's made problems which, like the serpent and the apple, he was not able to discern, though batteries of lawyers now demonstrate that the whole establishment has been on a collision course to a BTU catastrophe. The crucial fact is that it exists.

On reconsideration after *SoLa I*, FPC took our suggestion to heart and carefully scrutinized the supply situation. What it saw is most alarming. And it was this single over-riding fact that precipitated FPC's corrective action in *SoLa II*. It said:

> 61. The evidentiary fact which most concerns us is not in dispute: the traditional trend lines for measuring adequacy of supply, namely, reserves to production (R/P) and findings to production (F/P) ratios, are in a declining mode. In Opinion No. 546 it was stated that the ratio of new supply to net production of natural gas, both in the United States and for the Southern Louisiana area, was not significant in helping to determine reasonable rates. The statement was erroneous and non-supported, and we now correct it.

Comparatively speaking, SLA may be in a better supply position than other gas producing areas.[15] But it would be inappropriate for FPC to set rates for SLA based solely on internal data. For we are a country of *United* States, and SLA accounts for approximately 33.4% of the natural gas production in the continental 48 states.

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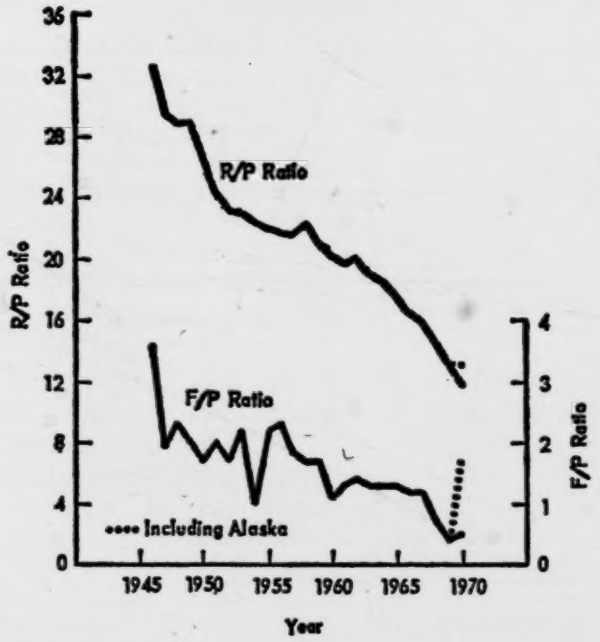
[15] SLA is the most prolific source of natural gas and her offshore potential is staggering. The quality of SLA gas is uniformly high, too. Staff has broken down its discussion of supply in terms of the seven geographically identifiable producing areas mentioned in note 8, *supra*. Staff Report No. 2, Ch. 2.

There is ample evidence from which FPC could make this conclusion. The F/P ratio for SLA has been less than unity for the past five years. In simple terms, this means that the industry is producing more natural gas from its wells than it is finding new reserves. This singular fact also proves, *a priori*, that the R/P ratio is in a "Declining mode". Staff has suggested that R/P ratio of 14 represents a national danger point. As the following table indicates, we are red-lined:

Figure 2
NATIONAL GAS SUPPLY TRENDS
R/P AND F/P RATIO
1946-1970



And in many ways the situation in SLA is even more immediate, for its resources have had to bear the brunt

of the increased national demand. In 1956, SLA's share of national natural gas production was only 12.8%. By 1970 it has soared to 33.4%. The large amounts of production necessary to accommodate this demand necessarily increased the denominator of the fraction and caused the R/P ratio for SLA to decrease from 21.0 in 1964 to its present level of 10.8. Staff Report No. 2, at 20.

National drilling data indicates a tendency over the past few years to drill fewer, but deeper, wells. SLA has certainly conformed to the latter, but exploratory efforts there have remained relatively stable. Producers drilled 2150 wells in SLA in 1956, the national peak year, and 2185 in 1970. Staff attributes this fact to the offshore leases. Unquestionably the offshore reserve possibilities are the major hope for a future supply. Currently 50% of SLA's production and about 25% of national production comes from this federal domain. But if SLA is to continue to supply its share of the national gas production, it must have incentives to encourage development of these resources.

Justice Jackson was certainly correct in suggesting that the inherently unique nature of gas is at the heart of the energy problem. But as this history of production in SLA itself demonstrates, "the wealth of Midas and the wit of man"—although they may be incapable of increasing nature's gifts—can encourage private entrepreneurs to develop the resources which God has bestowed upon the earth.

Fully aware of the critical gas supply shortage, and fully familiar with the factors which motivate producers to develop the resources to meet the demand, FPC approached its statutory task of establishing the "just and reasonable" rates for the sale of natural gas at the wellhead in SLA.

V. A Triumvirate of Incentives

As we noted above, Op: 598 established a three-point rate structure with the hope that it would "be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital." *FPC* v. *Hope Natural Gas Co.*, 1944, 320 U.S. 591, 603, 64 S. Ct. 281, ——, 88 L.Ed. 333, 345. First it established rates for both flowing and new gas which FPC believed would encourage exploration and development of the rich natural gas resources of SLA. Second, it ordered a $150,000,000 refund in accordance with the terms of the settlement proposal, but—in order to protect the capital position of the producers—allowed the producers owing these refunds to work them off by the commitment of additional reserves to the jurisdictional market. And third, it provided for periodic and contingent escalations of these ceilings.

We hold that this structure was amply supported by "substantial evidence on the record as a whole".

Flowing Gas

The genesis of many of the objections raised to the Op: 598 rate scheme is the specification of flowing gas rates. In *SoLa I*, FPC established two vintages of pre-October 1, 1968 gas, (i) gas committed under pre-1961 contracts could be sold at a maximum of 18.5¢/Mcf (onshore) or 17.0¢/Mcf (offshore), and (ii) gas committed under contracts signed between January, 1961 and October 1, 1968 could bring 19.5¢/Mcf (onshore) or 18.0¢/Mcf (offshore). Although we pointed out that our mandate was an affirmance of these rates, we poignantly emphasized that our opinion did not foreclose the possibility of change. On rehearing we reiterated: "We wish to make crystal clear the authority of the Commission in this case to reopen any part of its order that circumstances require the reopen." *SoLa I:* 444 F.2d at 126.

Not only did this invest FPC with the authority to redetermine *SoLa I* rates but it also enabled it to effectuate these rates by modifying the refund order of *SoLa I*.

In *SoLa II*, (Op: 598) FPC acknowledged its prior failure to take full account of the supply situation and redetermined the rate for flowing gas at 22.375¢/Mcf [16] which included an additional component for exploration and development. It abolished its prior distinction between first and second vintage gas and adopted a single rate for pre-October 1, 1968, flowing gas on the basis of Staff's breakdown on costs.[17] The costing methodology employed by Staff, with one minor exception,[18] was the same for *SoLa II* as for *SoLa I*. Thus, "by recommending a flowing gas price higher than that arrived in Op: 546, * * * Staff was candidly and correctly making the

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[16] The rate is one cent less for offshore gas.

[17]

1.	Cash Expense	1.81
2.	DD&A	4.00
3.	Return at 13 percent	5.46
4.	Total Production Cost	11.27
5.	E&D Expense	5.47
6.	E&D Return at 13 percent	1.10
7.	Total E&D	6.57
8.	Total at 14.73 psia	17.84
9.	Total at 15.025 psia	18.20
10.	Gathering Cost	0.51
11.	Regulatory Expense	0.17
12.	Production Tax	2.30
13.	Total	21.18¢ per Mcf

Op: 598, ¶ 154

[18] FPC did abandon the old BTU method of allocating drilling expenses for casinghead gas between the oil and the gas in favor of making a "direct assignment" based on survey data. This change may have accounted for 1¢Mcf difference, but it was noted that the difference "is more than accounted for by the range of estimates presented to us in the other choices implicit in the flowing gas costing methodology". Op: 598, ¶ 153.

flowing gas cost bear a part of the responsibility for further exploration—in other words it was looking to the total rate design." Op. 598, ¶ 155.

So, the legal issue precipitated by this change of Op: 598 over Op: 546 is whether flowing gas must bear a portion of the burden for the exploration and production of new gas in the future. Finding that the additional gas flow generated by this added increment of the flowing gas rate would aid producers to more fully exploit the natural resources of SLA, FPC held that they should. MDG, the principal opponent of this change, suggests that this is totally unacceptable. MDG argues that, (i) most of the capital used for the exploration and development of natural gas resources is derived from oil anyway, and that (ii) Op: 598 carries no assurance that any such internally generated funds will be used for exploration in SLA.

Public utilities, if indeed we may call the Natural Gas Industry a public utility, depend on various sources for their capital. See generally, 1 Priest, Principles of Public Utility Regulation, Chapter 13 (1969). Both equity and debt capital are used. But internally generated retained earnings are also used. Indeed, Professor Priest points out analogously, that 50% of the funds used for utility expansion in the electrical utility industry in the period from 1956 to 1965 were generated internally. Thus, we cannot ignore FPC's determination that the extra earnings to be acquired through income for flowing gas at the increased rate would generate additional, and needed, internal capital available for expenditure in the search for new gas reserves.

As to the contention of some consumers that the rates established by Op: 598 for flowing gas are not supported by the cost data in the record, we echo Commissioner O'Conner's prophesy, "The time is right to abandon costs

as the sole referential." [19] *Permian I*, 34 F.P.C. 244, 248-49. In affirming FPC's rate structure in *Permian*, the Supreme Court expressly recognized the possibility that price could be used functionally to encourage greater exploration and development. Likewise, in *SoLa I*, we specifically held that non-cost items which were properly labeled and justified could be interjected into the rate structure. Thus we hold that FPC properly determined that it was in the public interest to have the flowing gas rate bear part of the cost of future development.

This holding involves no great logical or economic leap. For the anomalous categorization of rates by date of contract rather than date of production yields a some-

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[19] Obviously FPC is currently minimizing or at least deemphasizing the use of unit costing as a basis for area rate regulation. Recognizing the wide fluctations in cost mathematics and the problems of assessment, appraisal and allocation which are so inextricably interwoven with the method, it said in Op: 595, only two months before it issued Op: 598:

> "We have re-examined many of the assumptions and conclusions implicit in the judgments expressed in *Permian, supra*, and *Southern Louisiana* and this reexamination has generally revealed a much broader zone of reasonableness within which the judgmental process must operate than is apparent from even a careful examination of these two decisions. Also, the seeming precision of the mathematical calculations has given the appearance of certitude which in fact does not exist." Texas Gulf Coast Area Rate Case, Op: 595, 45 F.P.C. 674, 686.

Thus, from the administrative standpoint at least, the unit costing method of rate calculation is, at most, merely a point of departure, whatever that navigational figure means in the quest for something even more enshrouded in fog. Final administrative determination of "just and reasonable" rates may get closer and closer to a basis of existing market conditions.

In *SoLa I* we held that it is proper for FPC to use non-cost elements to encourage exploration and development of natural gas resources. In Op: 598 FPC has done just that, though it masks its calculations as inaccurate cost computations. Because we find FPC's adoption of the terms of the settlement proposed to be supported by "substantial evidence on the record as a whole" we pretermit any further inquiry into the extent to which FPC may abandon or employ the concept of unit costing.

what artificial distinction. Natural gas is a fungible commodity as it comes from the bowels of the earth, neither severed nor identified to a particular contract. One molecule of gas flowing from a particular producer's well in SLA might be ultimately piped to a large industrial factory pursuant to a 1962 contract, which under the terms of Op: 598 would permit a maximum well-head price of 22.375¢/Mcf. At the same time its identical continguous twin might cook the dinner for the famed "little lady at the burner-tip" and, yet, yield a well-head price of 26¢/Mcf merely because it happened to be covered by a 1969 contract. It is therefore anomalous, if not downright inaccurate, to speak of "old" gas. There is no "old" gas. As it presses to freedom at the well-head, it is as "new" as any other of nature's offspring. It may be "old" in the sense that some arrangement confected long prior to its release made production possible. But if—and this can be no if—rates for so-called "new" gas must carry an increment to enable the continued resupply of this depleting commodity, this "old" gas, indistinguishable molecularly, must carry this burden like an added atom in its carbon ring.

There is no error. The rate is sustained.

New Gas

FPC established a maximum permissible rate for "new" gas, i.e. gas delivered under post-October 1, 1968, contracts, at 26¢/Mcf. No party[20] directly challenges this rate as being too low. Mobil contends that the rate only allows for "bare-bone" cost recoupment, and therefore, does not fulfil the duty to ensure the financial integrity

[20] APGA does contend that, by relying too heavily on industry-supplied AGA data, FPC has failed to follow the mandate of this Court in *SoLa I* to premise its future rate-making on supply and demand. As we demonstrate in note 13 *supra*, APGA's notion that there is no supply shortage is blindly unrealistic.

of the natural gas industry and attract or generate capital for future exploration and development of natural gas reserves. We are convinced that this rate clearly falls within the "zone of reasonableness" latitude which Courts must grant to FPC action.

FPC began its cost calculations for new gas by categorically rejecting "any 'what-the-traffic-will-bear' approach" and adhering "to the judicially required test of a price equal to but no higher than the level required to bring forth the necessary supply." Op: 598, ¶ 101. And in making its initial determination of targeted supply, it started "from the premise that we are not bound to provide a price to satisfy all gas demands." Op: 598, ¶ 74.[21]

[21] FPC obviously realized that supply is not the only market variable that is a function of price. In the short-term market for natural gas, both supply and demand are relatively inelastic, i.e. neither will shift drastically in the short-run with an increase or decrease in price. Mobil has pointed out in this appeal that, perhaps the burgeoning demand for natural gas, which it attributes at least in part to artificially deflated rates in the past, has made a significant contribution to the energy crisis. The theory behind the incentives implemented by Op: 598 is that supply is at least sufficiently elastic in the short-term to prevent an immediate catastrophe. Calloused, or perhaps feeling so, from hundreds of David's little slings as its orders were reversed or modified by a nation-wide system of courts whose power to act stemmed from the sheer accident of residence of some party, animate or corporate, and a stop watch race to the courthouse, FPC cautioned against holding it to specific productivity:

> It is not our duty to fix a rate to meet any and all possible demands for natural gas. When all demands for natural gas were being met, by and large, that is, from the beginning of the post-World War II expansions of the pipelines until the latter part of the 1960's, it was possible to indulge in the luxury of theorizing about maximums and minimums in level of service. As we see the situation today, there is ample justification of our fixing as one immediate goal a containment of the panic psychology which fears of shortage always engender. Actual shortages are most significant as they portend for the whole country problems in gas supply, and that psychological pressure is being keenly felt right now. Therefore, we will not make our future task more difficult by setting supply goals

The idea that price should be used functionally to elicit supply is not novel. In *SoLa I* we echoed Justice Jackson's 1945 wisdom in *Colorado Interstate Gas Co.* v. *FPC*, 1945, 324 U.S. 581, 612, 56 S.Ct. 829, 843, 89 L.Ed. 1206, ——:

> Far-sighted gas-rate regulation will concern itself with the present and future, rather than with the past, as the rate-base formula does. It will take account of conditions and trends at the source of the supply being regulated. It will use price as a tool to bring goods to market—to obtain for the public service the needed amount of gas. Once a price is reached that will do that, there is no legal or economic reason to go higher; and any rate above one that will perform this function is unwarranted. * * * On the other hand, if the supply is not too plentiful and the price is not sufficient incentive to exploit it and fails to bring forth the quantity needed, the price is unwisely low, even if it does square perfectly with somebody's idea of return on a "rate base."

But quantifying this functional relationship, especially in a market of such imponderables, is another matter, for "the relationship between price and supply brought to the market over time depends upon numerous factors including monetary inflation, changes in real cost of input resources, availability of input resources, changes in alternative investment opportunities, development of new producing areas, size of prospective reservoirs, changes in business confidence, degree of directionality of exploratory efforts, changes in industry technology, and other factors influencing business decisions." Op: 598, ¶ 77. With this many variables, it is impossible, with any de-

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which, if they are later not met, will lend a false credence to the negativism about our resources capability which is already spreading widely. The rate level and rate design features of the settlement proposal give us a starting point for proceeding in an orderly fashion.

Op: 598, ¶ 70.

gree of precision likely to satisfy the momentary opponent's fetish for quantification, to determine the likely quantitative effect on supply of a change in rate ceiling. Though it detailed a breakdown of costs [22] for new gas, FPC concluded that because of the uncertainty of this element and others, a 4-5¢ zone of reasonable deviation existed.[23] Accordingly, it adopted without reservation the

[22] The breakdown of new gas costs given by Staff Witness Engel and accepted by FPC as a reference point for its Matrix of cost components was as follows:

		Current	*Future*
1.	Successful Well Costs	3.91	4.29
2.	Lease Acquisition Costs	1.37	1.37
3.	Other Production Facilities	0.88	0.88
4.	Subtotal	6.16	6.54
5.	Dry Hole Costs	2.12	2.67
6.	Other Exploration Costs	1.81	1.81
7.	Subtotal	3.93	4.48
8.	Production Operating Expense	3.10	3.10
9.	Return on Investment	8.41	8.93
10.	Return on Working Capital	0.44	0.45
11.	Net Liquid Credit	(3.89)	(3.89)
12.	Regulatory Expense	0.17	0.17
13.	Subtotal	18.32	19.78
14.	Royalty at 15%	3.23	3.49
15.	Subtotal at 15.65 psia	21.55	23.27
16.	Subtotal at 15.025 psia	22.10	23.87
17.	Area Gathering	0.51	0.51
18.	Production Tax	2.30	2.30
19.	Total	24.91	26.68

Op: 598, ¶ 127.
See note 405-1 *supra*

[23] In its recent bevy of area rate cases, FPC has realized that its calculations are necessarily inexact. In the Texas Gulf Coast Area Rate Case, Op: 595, 1971, 45 F.P.C. 674, 687 it said:

"The cost computations used in this and other area rate proceedings seem to be mathematically precise. They are not

[Footnote continued on page 38]

26¢/Mcf price of new gas established by the proposed settlement agreement. As to defining the rate to supply relationship, FPC said in effect that "we know that it's positive, but we can't say just how positive". FPC has to be no more prescient. Nor could we. It seriously believed that the total rate structure of Op: 598 would call forth a sufficient supply to meet projected needs.

The target goal for the 1971-1975 period was approximately 45-50 trillion cubic feet, keeping relatively constant SLA's approximate 33.4% contribution to total national demand. The added incentive of a contingent escalation on flowing gas rates could reasonably be thought to encourage the commitment of 15 Tcf within the 5 year period. Likewise, the refund credit structure would stimulate another 15 Tcf of new reserves. The remaining 15 Tcf needed to make up the quota would depend primarily on the basis of the inherent incentive of the rate schedule. But FPC did not stop there. Since no one disputes that the greatest prospects for development of SLA's natural gas resources are the offshore leases,[24] FPC gave an added incentive for offshore drilling. Gas

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[23] [Continued]

Allocations of costs are by nature matters requiring a substantial amount of judgment."

Realizing the limitations on its ability to reflect actual costs of individual producers in an industry-wide area rate, and the fluctuations which were bound to result from making the effort, FPC abandoned all efforts at quantifying non-cost factors in favor of establishing a permissible zone of deviation for costs. In *Texas Gulf Coast*, as here, it found that new gas costs could fall at any point within an approximate 4¢/Mcf range. Id. at 705.

[24] This demonstrates the difficulty of pin-pointing all of the causes of the natural gas supply shortage. Until very recently, the federal government, which controls the vast acreage of almost assured reserves, has had a moratorium on leasing—largely because of ecological factors. Without leases, the producers may not drill—no matter how attractive the rate structure. See generally Staff Report No. 2.

produced from the offshore leases is not subject to the 2.3¢/Mcf Louisiana severance tax.[25] By allowing offshore gas to be sold at the same maximum rate as onshore gas, which included the tax, FPC not only took into account possible greater costs of production, but simultaneously gave a strong stimulant for development of these resources.

The 26¢/Mcf rate for gas delivered under a post-October 1, 1968 contract which FPC adopted in Op: 598 clearly falls within the range of cost estimates which the evidence discloses. Accordingly, FPC properly declined to make what would be a necessarily speculative quantification of non-cost elements. The rates for so-called "new" gas are sustained.

Those Elusive Refunds

Because the flowing gas rates which many of the producers in SLA have been collecting subject to refund in the past exceeded the rates determined to be "just and reasonable" by FPC in Op: 598, FPC ordered substantial refunds to remedy the over-charge. From a supply-oriented perspective, however, FPC also realized that refunding was a significant disincentive for current and future exploration and development and a possible impairment of the current capital situation of many companies. Accordingly, Op: 598 adopted a procedure to allow those producers owing refunds to cancel their refund obligations by committing new gas reserves to ju-

[25] After August 1, 1972, Louisiana severance tax will be calculated on the basis of 2.3¢/Mcf or 11.5% of the value of the gas at the time and place of severance, whichever is greater. Assuming—and we make no suggestion that this is the proper manner of calculation—the well-head rate for gas is used for calculating the tax, the tax on a 26¢ Mcf would be 2.99¢. Recognizing this potential obligation of the producers, FPC issued Order 456 on August 4, 1972. Order 456 allows increased rate filing under Section 4(b) to go into effect without the 30 day notice period.

risdictional sales in SLA. To do this, a refund credit of 1¢/Mcf for new gas committed to the interstate market was allowed by FPC.[26] The entire refund program is vigorously attacked on appeal.

Basically, the attacks fall into one of two categories: (i) that FPC exceeded its authority and the mandate of *SoLa I* by reducing the total amount of refund from $375,000,000 in *SoLa I* to $150,000,000 in *SoLa II*, and (ii) that the refund credit program arbitrarily and capriciously discriminates against producers, like Mobil and Amoco, who have entered into voluntary companywide settlement agreements by which they have already made substantial refunds and reduced the rates for flowing gas in favor of relative intransigents like Humble,[27] Shell, Superior Oil, and the California Company, who have continued to charge rates subject to refund now found to be excessive.

The Amount of the Refund

The gist of the first argument is that FPC has no power to alter or modify refund obligations which were established in Op: 546 and affirmed by this Court in *SoLa I*. Because the rates for flowing gas under the

[26] If a producer elects to discharge his refund obligations in this manner he must offer 50% of the new reserves to the same customer to whom the cash refund is owed. Only if that offer is rejected in writing may he discharge any of his obligation with respect to that customer by commitments to another customer. This 50% rule is attacked by NYPSC as being unfavorable to the consumer to whom the obligation is due, and on the other hand by Placid as putting too many restrictions on the producer owing the refunds. We find that the manner in which FPC ordered the discharge of the refunds is amply supported by the credible evidence. It fairly balances the interests of the producers with those of the consumers.

In the event that there are remaining refund obligations on October 1, 1977, they are to be paid in cash with interest from August 1, 1971.

[27] In tune with its world-wide jingle to "change our name but not our stripes", Humble is now Exxon.

SoLa I rate scheme were significantly lower than the rates established by Op: 598, the refunds which were calculated under that basis were approximately $375,000,000. Under the terms of the settlement proposal, accepted by FPC in Op: 598, a stipulated refund obligation of $150,000,000 is to be imposed upon the various producers in accordance with the following schedule:

(a) Prior to January 1, 1965, amounts collected above the just and reasonable rates of 20.625 cents per Mcf (onshore) and 19.625 cents per Mcf (offshore).

(b) From January 1, 1965, to September 30, 1968, amounts collected above the just and reasonable rates of 21.25 cents per Mcf (onshore) and 20.25 cents per Mcf (offshore).

(c) From October 1, 1968, to January 1, 1971, refunds shall be calculated by applying 30.5 percent of the difference between revenues for this period based on rates in effect prior to October 1, 1970, and the revenue which would have resulted for this period through application of rates established in Opinion Nos. 546 and 546-A, as modified by Opinion No. 567.

(d) After January 1, 1971, refunds shall be made for amounts collected in excess of the ceiling prices established herein.

Op: 598, ¶ 170.

The most fundamental argument raised by the opponents of the proposal is that the prior refund obligation of $375,000,000 was affirmed by this Court in *SoLa I*. But in making this argument the parties ignore, or gloss over, our opinion on rehearing. For there we categorically rejected the notion that the label "affirmance" could possibly impair FPC's ability to alter or modify *any* of the provisions, particularly the refund provisions, of its *SoLa I* rate scheme if it believed that the exigencies of

the gas industry required more effective remedial measures. Thus, we held:

> "Under Section 19(b) of the Natural Gas Act, this Court has the broad remedial powers that inhere in a court of equity and pursuant to our equitable powers we make it part of the remedy in this case that the authority of the Commission to reopen any part of its orders, including those affecting revenues from gas already delivered, is left intact. The Commission can make retrospective as well as prospective adjustments in this case if it finds it in the public interest to do so. * * * It may be that the Commission will decide that the refunds it has ordered are just and reasonable or at least that their significance to the public interest is outweighed by the confusion and delay that would result from their reopening. In this event, the Commission will allow its refund orders to stand as they are. Or it may be that the refunds are too burdensome in light of new evidence to be in the public interest. In that case it is our judgment that the Commission shall have the power and duty to remedy the situation by changing its orders.

SoLa I: 444 F.2d at 126-27 (on rehearing).

This is the law of the case, and so it stands.[28]

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[28] The Supreme Court has also recognized that an administrative agency has the flexibility to modify an order which has not been unequivocally affirmed by a court of law. In United Gas Improvement Co. v. Callery Properties, 1965, 32 U.S. 223, 229, 86 S.Ct. 360, —— 15 L.Ed.2d 289, ——, Justice Douglas wrote:

> We also conclude that the Commission's refund order was allowable. We reject, as did the Court of Appeals below, the suggestion that the Commission lacked authority to order any refund. While the Commission "has no power to make reparation orders," Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 618, 88 L.ed. 333, 353, 64 S.Ct. 281, its power to fix rates under § 5 being prospective only, Atlantic Refining Co. v. Public Service Comm'n, supra, 360 U.S. at 389, 3 L.ed.2d at 1319, it is not so restricted where its order, which never became final, has been overturned by a reviewing court. Here the original certificate orders were subject to judicial review;

The chosen refund amount is also challenged on several other bases. NYPSC contends that there is no evidentiary basis for the $150,000,000 figure. It also suggests that any incentive function to be served a refund work-off program would be an impermissible superfluity since the "just and reasonable" rates established by FPC are by definition those rates which will maintain confidence in the industry and attract capital. Finally, it is contended that the reduction in the amount of refund from the *SoLa I* order gives a competitive advantage to the proponents of the settlement agreement.

The short answer to the contention of some of the consumers that the refund scheme is not supported by the evidence is that the stipulated refund amounts are more beneficial to their particular interests than would be a refund order based on the "just and reasonable" rate established for flowing gas by Op: 598. The flowing gas rate sanctioned by Op: 598 is 22.375¢/Mcf (onshore) or 21.375¢/Mcf (offshore). The stipulated refunds for first vintage gas, however, provided for a refund of amounts in excess of 20.625¢/Mcf (onshore) or 19.625¢/Mcf (offshore) for the pre-1965 period and 21.25¢/Mcf (onshore) or 20.25¢/Mcf (offshore) for the period from January 1, 1965 to September 30, 1968. If the refunds had been calculated on the basis of the rates established for flowing gas and approved by us in this Opinion, they would have been substantially *less* than the $150,000,000 about which some consumers complain. Thus, we hold that the evidence amply supported the reduction in amount of total refund ordered in *SoLa II*. FPC does not *have* to order

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and judicial review at times results in the return of benefits received under the upset administrative order. See Securities & Exchange Comm'n v. Chenery Corp., 332 U.S. 194, 200-201, L.ed. 1996, 2001, 67 S.Ct. 1575. An agency, like a court, can undo what is wrongfully done by virtue of its order. Under these circumstances, the Commission could properly conclude that the public interest required the producers to make refunds.

refunds under the terms of the Natural Gas Act.[29] It *may* do so. And to the extent that it does order refunds, it is empowered to adopt a schedule or structure of refunds which it, in its administrative discretion and expertise, believes will fairly balance the interests of both consumers and producers while achieving the overriding public interest, that interest in the 1970's being the quest for an increased supply to meet an insatiable demand.

Neither will we hold that FPC is limited to the discredited contention that the rate of return must be self-sufficient as an incentive. Not the least of the problems under the anomalous structure of utility type regulation of an activity which combines both a service and a sale of a depleting asset with no statutory compulsion as to future activity save continuance of specific sales is the lack of any assurance that revenues generated by even the most generous of incentive rates will be invested in new production or reserves of interstate gas. Among large integrated producers there is always competition between oil or gas in the use of these dollars. And among all, the choice is even more severe as between int*ra* and int*er* state gas sales. FPC is entitled to formulate its incentive programs in the mode best suited to accomplish the various goals of the regulatory undertaking. Amoco suggest that FPC could have obviated the need for the refund credit and contingent escalation incentives adopted by Op: 598 by establishing the "just and reasonable" rate of flowing gas at 26¢/Mcf, and the rate for new gas at 30¢/Mcf or higher. Given the financial posture of the various producers, and taking full account of the consumer interests, FPC had the right to conclude that it was more in the interest of consumers for the producers to

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[29] § 4(e) of NGA, 15 U.S.C.A. § 717c(e); Mesa Petroleum Co. v. FPC, 5 Cir., 1971, 444 F.2d 182; Continental Oil v. FPC, 5 Cir., 1967, 378 F.2d 510; Public Service Commission for New York v. FPC, D.C. Cir., 1964, 329 F.2d 242, *cert. denied sub. nom.*, Prado Oil Co. v. FPC, 1964, 377 U.S. 963.

keep those funds which were paid in the past than to pay an even greater rate in the future. And given that possibility, we cannot say that FPC erred in adopting the refund provisions as it did.

As to the argument that the reduction in refund obligations from *SoLa I* to *SoLa II* benefited some producers more than others, even FPC recognized that the cosmic plan which it adopted has some atomic flaws. It confessed: "Candor requires us to admit that some of the predicted inequities as among producers will surely occur, and those who have attempted to work within 'the system' are comparatively disadvantaged." Nevertheless, FPC concluded that the overall structure would stimulate greater exploration and development and have a general pro-competitive effect. We will not reject an administrative decision merely because one producer's piece of cake is iced and another's is not. The crucial factor, in total alignment with both *Permian* and *SoLa I*, is that both get *some* cake. Given the wisdom of the administrative desire to elicit new supply, and accepting the proposition that the incalculable relationship between rate and supply is positive, we refuse to tamper with an overall program which effectively exploits that relationship. FPC's order setting the total refund obligation of all gas producers in SLA is therefor fully sustained.

The Refund Credit

Op: 598 provided for a refund credit of 1¢/Mcf committed to the interstate market in SLA. This refund work-off is vigorously challenged by major producers Mobil and Amoco and consumer advocates NYPSC and MDG. The producers' main argument is based on the fact that under the structure of NGA and unlike that of most regulated utilities, the obligations arise from a private contract—here between (i) producer and (ii) pipe-

line purchaser.[30] Consequently, the argument goes, it is unrealistic to set up a refund structure which is industry-wide in terms of benefits but necessarily individualized as to in-put. As Amoco puts it: "refund amounts are individual liabilities, not industry burdens." (Amoco Initial Brief at 40.) Amoco contends that the refund credit coupled with the contingent escalation for flowing gas places burdens unevenly within the industry. The argument runs this way. Those producers who have adamantly adhered to excessive prices under their old gas contracts will use all, or the majority, of their new commitment to interstate sales to work-off their heavy refund obligations—thus, netting 1¢/Mcf more for their new gas than Amoco and Mobil.

In addition to this 1¢/Mcf disparity in the net yield of new gas, Amoco, Mobil, and others who have worked within the system and made voluntary company-wide settlement agreements and substantial refunds will have to credit their new additions to the interstate market towards the target goals which trigger the contingent escalations. Thus, the argument goes on, once Amoco and Mobil have committed enough new reserves to trigger the contingent escalation, then Humble and Shell and their fellow "delinquents" [31] will be able to reap the bene-

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[30] United Gas Pipe Line v. Mobil Gas Service Corp., 1956, 350 U.S. 332, 76 S.Ct. 373, 100 L.Ed. 373; United Gas Pipe Line Co. v. Memphis Light, Gas & Water Division, 1958, 358 U.S. 103, 79 S.Ct. 194, 3 L.Ed.2d 153.

[31] On reading the briefs of Amoco and Mobil, one might conclude that they were the only ones who had private, company-wide settlement agreements. But as the following table reveals, the list is long and it includes both Shell and Humble:

Tabulation of Individual Company Settlements

Champlin Oil & Refining Co.	23 FPC 681
Tidewater Oil Co.	27 FPC 1267
Ohio Oil Company	27 FPC 1373
Shell Oil Company	28 FPC 257

[Footnote continued on page 47]

fits by collecting the additional revenue for their sales of flowing gas. It is a double-edged sword.

FPC realized that its refund credit program would not benefit all producers equally. The Supreme Court recognized in *Permian* that contiguous, homogeneous molecules of natural gas might, consistent with the terms of NGA, bring different prices. FPC's statutory authority to order refunds is clearly discretionary. § 4(e) of the Natural Gas Act, 15 U.S.C.A. § 717c(e).[32]

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[31] [Continued]

F. A. Callery Inc. Francis A. Callery Callery Properties Inc.	28 FPC 849
Pure Oil Company	28 FPC 889
Bel Oil Corp.	28 FPC 1006
Cities Service Oil Company	28 FPC 1108
Amerada Petroleum Corp.	29 FPC 204
R. H. Goodrich	29 FPC 397
Gulf Oil Corporation	29 FPC 837
Sinclair Oil & Gas Co.,	30 FPC 5
Hunt Oil Company	30 FPC 220
Texaco Inc.	30 FPC 1631
Southwest Gas Producing Company, Inc.	31 FPC 192
Socony Mobil Oil Co., Inc. (Mobil)	31 FPC 1101
Sohio Petroleum Co.	31 FPC 623
Humble Oil & Refining Company	32 FPC 49
Sun Oil Company	32 FPC 894
The Atlanic Refining Co.	32 FPC 933
Union Oil Co. of California	32 FPC 1336*
Pan American Petroleum Co. (Amoco)	35 FPC 502

*Limited to certain dockets.

If the *SoLa II* rates were lower than those established in these agreements, the private settlements would have been worthwhile. As it turns out, FPC was more generous in *SoLa II* than was anticipated. But this clearly furnishes no basis for attack. We have not examined the provisions of any of these private settlements but are informed that many of them also include the forgiveness of substantial refund obligations.

[32] See also Mesa Petroleum Co. v. FPC, 5 Cir., 1971, 441 F.2d 182; Continental Oil Co. v. FPC, 5 Cir., 1967, 378 F.2d 510; Public Service Commission for the State of New York v. FPC, D.C. Cir.,

In the Hugoton-Anadarko Area Rate Case, 9 Cir., 1972, 466 F.2d 974, our Brothers of the Ninth Circuit reviewed Op: 586, which customized refund obligations to make a particular allowance for the position of the Phillips Petroleum Company. Several parties to this appeal suggest that *Hugoton-Anadarko* is a strong precedent for the exercise of FPC discretion. The Associated Gas Distributors (AGD) suggest that FPC's discretion in Op: 598 is even more sustainable than that in *Hugoton-Anadarko* because (i) in *Hugoton-Anadarko* FPC was motivated to protect the interest of a single private producer, whereas in *SoLa II* the refund provisions give a direct benefit to the industry as a whole, but more significantly a benefit to consumers and the public, and (ii) the refund provisions of *Hugoton-Anadarko* were adopted from the untested settlement proposal whereas the *SoLa II* proposal was subjected to cross-examination and additional evidentiary scrutiny.

On the other hand, the opponents suggest that *Hugoton-Anadarko* is absolutely no authority for what FPC did in Op: 598. Mobil demonstrates that in *Hugoton-Anadarko*, FPC employed a *Grigsby* formula in requiring refunds. MDG suggests that the *Hugoton-Anadarko* refund provisions prevented discrimination against a peculiarly situated producer, while the Op: 598 refund credit fosters discrimination between the various producers. Finally, NYPSC, brightening up a gaseous problem by a navigational figure, suggests that the *de minimus* provisions of *Hugoton-Anadarko* are "360° out of phase" with FPC action in Op: 598. Taking the effect of the refund credit as a whole, we find that *Hugoton-Anadarko* is authority for the proposition that FPC may tailor its refund orders to the particular needs of the industry in a given area. This it did in Op: 598. If it

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1964, 329 F.2d 242, *cert. denied sub. nom;* Prado Oil and Gas Co. v. FPC, 164, 377 U.S. 963, —— S.Ct. ——, 12 L.Ed.2d 735.

has traversed 360°, it is back to its original azimuth—it has come full circle. The same rationale which supports FPC's discretion in granting a special dispensation in *Hugoton-Anadarko* likewise supports its discretion in Op: 598. Such is the essence of administrative discretion.[33]

We therefore hold that on the record before us, FPC was acting within the bounds of its discretion when it adopted the refund credit work-off program.[34]

Escalations

In addition to the other customized features which we have already discussed, Op: 598 provides for automatic, periodic escalations of ceiling prices on both flowing and new gas and contingent escalations on the price of flowing gas. The maximum rate for flowing gas will increase .5¢/Mcf on October 1, 1973. The maximum rate for new

[33] The consumers argue that there is no assurance that the program will inure to the benefit of the aggrieved consumer who would have gotten the refund but for the credit. Op: 598 does provide, however, for a first rejection by the party to whom the obligation is owed. It also requires the producers to discharge at least 50% of their obligation by new commitments to these customers or receive written refusals of a bona fide offer. We hold that these protections are supported on the record as a whole. And, even assuming there are some minor infirmities, we are unwilling to reject a program which provides an obvious positive stimulant for cultivation of reserve possibilities.

[34] We are not unmindful of the suggestion of the named petitioner, *Placid Oil Co.*, that the refund credit system of Op: 598 should be modified by (i) abolishing the restriction that the refund obligations must be worked off through additional commitments solely in SLA, (ii) allowing all, rather than only 50%, of the refund obligations to be reduced through commitments to customers other than those who would receive the cash refund were it not for the credit program, and (iii) establishing a more particularized system of special dispensations for producers who are unable to discharge their refund obligations in this altenative manner. These particulars are within the province of FPC's administrative discretion.

gas will increase by 1¢/Mcf on October 1, 1974. Some consumer advocates here argue that these automatic escalations are not supported by the empirical cost data upon which FPC based its rate structure. For the reasons which we have outlined in our discussion of the role of costs in FPC's determination of "just and reasonable" rates for both flowing and new gas, see notes 19 & 23 *supra*, we hold that these periodic escalations were a proper subject for the exercise of administrative discretion and clearly fall within that "zone of reasonableness" which we allow FPC on review. See Hugoton-Anadarko Area Rate Case, 9 Cir., 1972, 466 F.2d 974.

The contingent escalations of flowing gas rates are keyed to industry-wide dedication of additional natural gas to the jurisdictional market. All producers may charge an additional .5¢/Mcf when 7½ Tcf of new gas reserves are dedicated to the interstate market. There are also successive half-penny increases when the new reserve dedications on an industry-wide basis reach 11¼ Tcf and later at 15 Tcf. The principal objection to these escalations has already been discussed. Since new reserves committed under the refund credit provisions of Op: 598 may not be used to trigger the industry-wide contingent escalations, the producers with relatively insignificant refund obligations strenuously argue that it is competitively disadvantageous for them to commit new reserves to the jurisdictional market. "Why should we contribute 7½ Tcf of new reserves to the jurisdictional market for the benefit of the industry as a whole, when our competitors are reaping individual refund credit benefits from their new commitments?" they ask. Of course, the answer is that half a loaf is better than no loaf at all. As we have already shown, an administrative choice is not to be rejected merely because one party may get icing on his cake while another gets only cake. FPC found that the contingent escalation program would tend to encourage producers having refund obligations to

commit new reserves to the interstate market. To that considerable extent, the program represents a permissible course of action and instead of exciting protest by consumer groups, it should allay the fears that revenues generated by the increased rates will actually go into exploratory and development drilling for new production and reserves. And for that unnamed new market entrant, for whom much concern is expressed, we fail to see why he would be in the least bit dissuaded from committing new reserves at 26¢/Mcf by the fact that it might allow some of his competitors to raise their 22.375¢/Mcf flowing gas price by a half-penny. In short, we sustain the escalations in full.

VI. Other Provisions

Of Moratoria

FPC has attempted to interject a modicum of temporal stability into the rate scheme by imposing a moratorium on increased rate filings under § 4 of the Act in excess of the rates authorized by Op: 598 for a period of approximately 5 years. Mobil challenges this restriction as being violative of § 4. We believe that the provision was clearly a lawful exercise of administrative judgment. Not only is it the last word in the sense of its innate authoritativeness, but what the Supreme Court said is the latest and finest word:

> Certain of the producers urge that §§ 4 and 5 must in combination be understood to preclude moratoria upon filings under § 4(d). They assert that the period of effectiveness of a rate determination under § 5(a) is limited by § 4(e); they reason that § 4(d) creates an unrestricted right to file rate changes, and that such changes may, under § 4(e), be suspended for a period no longer than five months. If this construction were accepted, it would follow that area proceedings would terminate in rate limitations that could be disregarded by producers five

> months after their promulgation. The result, as the Commission observed, would be that "the conclusion of one area proceeding would only signal the beginning of the next, and just and reasonable rates for consumers would always be one area proceeding away." 34 FPC, at 228.

Permian, supra at 779, 88 S.Ct. at ——, 20 L.Ed.2d at 343. See also *SoLa I:* 429-30.

There are also other substantial reasons for rejecting the producers' attack on the moratoria provisions. The marrow of their argument is that due to inflation and other economic factors, costs are very likely to rise substantially during the term of the moratorium. But two safeguards convince us that, if and when that contingency occurs, FPC is ready, willing, and able to make appropriate adjustments. First, the costing on 1969 data was relatively current and to a significant degree, the incentives established by Op: 598 apart from the rates themselves serve to bolster the financial position of the producers and protect them against rising costs. These are, of course, the provisions providing for the retention of large amounts of capital through the refund discharge program and the periodic and contingent escalations. Second, there are several alternative methods by which a single aggrieved producer may establish higher rates as his circumstances warrant. See Part VII, *infra.* Thus, the system is so structured that FPC can retain industry and area wide rate stability for a period of at least five years while simultaneously protecting the financial integrity of the individual producer. And if the change in circumstances is so widespread that the area rate is no longer economically feasible as set, FPC has the power to lift its moratorium or establish new area rates, or both.

For these reasons we hold that the moratoria provisions of Op: 598 are an appropriate exercise of administrative discretion supported by "substantial evidence on the record as a whole".

Casinghead Gas

Casinghead gas has traditionally been the by-product of the often more lucrative search for oil. In both *SoLa II*, Op: 598, and the Texas Gulf Coast Area Rate Case, Op: 595, FPC has abandoned any distinction in maximum permissible rates of gas on the basis that some of it may be associated with the production of oil. We believe that several considerations support this course of action: (i) "the exigencies of administration demand the smallest possible number of separate area rates", *Permian, supra* at 761, 88 S.Ct. at ——, 20 L.Ed.2d at 333, (ii) there is a serious problem of allocating the proper amount of exploration and development expenses between oil and gas, see *SoLa I:* 422 n.30, (iii) imposing a lower price on casinghead gas might " 'invite the divergence of such case to the intrastate market,' " Op: 598, ¶ 167, and (iv) making the production of casinghead gas economically unfeasible might encourage profit-minded producers to flare it rather than market it—thus making natural gas in SLA not merely a wast*ing* but a wast*ed*, asset. Worse, perhaps this would excite every nearby camper, hiker, and nature lover into a hoped-for class action to add the further, and unneeded complication of an EPA impact statement in every FPC certification rate case. Cf. *Harrington Manufacturing Co.* v. *White*, 5 Cir., 1973, —— F.2d [No. 71-2032, March 13, 1973]. For all of these reasons, we believe that FPC acted within the bounds of administrative propriety in abandoning any such distinction.

Bastian Bay

In Op: 598, ¶ 166, FPC specifically excluded from the applicability of its order the "just and reasonable rates" for the Rayne Field and Bastian Bay sales. No party seriously contends that it would be appropriate for FPC to include the Rayne Field proceeding, which is now

pending review in the D.C. Circuit. But Amoco strenuously contends that it was error for FPC to exclude from the provisions of Op: 598, the rates for its largest delivery of natural gas, i.e. Bastian Bay.

FPC and two intervening parties, Humble and the Pipe Line Purchaser Group seek to justify this exclusion. Their arguments are essentially two. They argue that it is within the authority of FPC to delineate the scope of its own proceedings. They also contend that Amoco is premature in its objections since there is no indication that its Bastian Bay sale will receive disparate treatment, and indeed, FPC's actions with regard to the Rayne Field proceedings would tend to indicate that the Bastian Bay transaction will be given every benefit allowed to other producers under the terms of Op: 598.

We find this reasoning to be very persuasive. The Bastian Bay commitment is not necessarily of the same genre as the typical wellhead sale of an Mcf of gas. *Cf. United Gas Improvement Co.* v. *Continental Oil Co.*, 1965, 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 1466; *Continental Oil Co.* v. *FPC*, 5 Cir., 1966, 370 F.2d 57, *cert. denied*, 1967, 388 U.S. 910, —— S.Ct. ——, —— L.Ed.2d ——. It is a lump sum of sale of in-place reserves. Thus, there are significant pragmatic reasons to justify FPC's separate treatment. But this conclusion does not in any way foreshadow any particular resolution on the merits. On the contrary, we leave the ultimate merit determination of maximum permissible rates for delivery of natural gas at Bastian Bay to the specific expertise of FPC. Naturally, this also leaves to Amoco all available administrative and judicial remedies. Our refusal to take requested specific action is a recognition that enforcement of Op: 598 does not cut off Bastian Bay interest holders from further relief completely unfettered by the refusal of FPC (or us) to take care of it now.

The Division Date Between New and Flowing Gas: October 1, 1968

The Municipal Distributors Group (MDG), as a corollary of its argument that flowing gas may not be made to bear a portion of the burden for exploration and development of new natural gas reserves, urges that the administratively chosen division date of October 1, 1968, is not supported on the basis of the record. FPC has employed this date in most of its area rate cases.[35] Producers in SLA were initially put on notice when *SoLa II* proceedings first commenced that new gas rates might be subject to future alterations. We fail to see how this purely administrative matter could possibly have prejudiced any party.

Royalty Payments

Mobil attacks the royalty component of the rate calculations on the basis of its punative inadequacy.

It all started with *J. M. Huber Corp.* v. *Denman*, 5 Cir., 1966, 367 F.2d 104, and *Weymouth* v. *Colorado Interstate Gas Co.*, 5 Cir., 1966, 367 F.2d 84, where we referred to FPC's primary jurisdiction the issue of whether gas royalties are "sales of gas for resale in interstate commerce." FPC answered affirmatively, thereby subjecting the royalties to FPC administrative ceilings. In *Mobil Oil Corp.* v. *FPC*, D.C. Cir., 1972, 463 F.2d 256, *pet. for cert. field, Mobil Oil Corp.* v. *Matzen*, [No. 71-1169], the D.C. Circuit reversed. Since the royalty contracts are

[35] Because the Hugoton-Anadarko Area Rate Case, Op: 586, *aff'd.*, 9 Cir., 1972, 466 F.2d 974, adopted the terms of a settlement proposal, a different date was chosen. The October 1, 1968 date was used by FPC in the Texas Gulf Coast Area Rate Case, Op: 595, and the Other Southwest Area Rate Case, Op: 607, however. Since there is a great degree of overlapping, not only from the administrative angle, but also of producers, we believe that this practice will facilitate more efficient regulation by FPC.

not, under this decision, subject to the same administrative jurisdiction as the producer's rates, Mobil argues that the rate schedule fails to take account of the possibility that royalty obligations might require a greater portion of the new rate than FPC thought.

Of course the royalty obligations of the producers are cost components of the rate structure. Any alteration of this component would necesarily alter the departure point of the rate calculations. And under the holding of the D.C. Circuit in *Mobil*, this would be an *Erie* determination of the contract stating the royalty percentage based upon the applicable principles of state law—totally beyond the control of the federal regulatory agency charged with the responsibility of regulating natural gas rates.

But we are not willing to alter or stay the implementation of area wide rates for the entire industry merely on the basis of what *might* happen to *some* producers' costs *if* this statement of the law prevails.

If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief. *Permaian* contemplated it. FPC has on occasion given it. E.g., Op: 649, "Opinion and Order Granting Special Relief and Terminating Proceedings" (February 21, 1973). And we find it to be far preferable to speculative prophesies of future royalty components. If the royalty obligations are such as to make the rates established by Op: 598, and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will certainly have recourse to the administrative process. And, as with the moratoria provisions, if FPC determines that future events substantially change the rate structure for the industry as a whole, it may make appropriate changes.

Charges for the Transportation of Liquids and Liquefiable Hydrocarbons

Op: 598 established minimum transportation rates to be paid by the producers to pipelines who may transport liquid or liquefiable hydrocarbons in conjunction with the sale of natural gas.[36] The rate is attacked by Mobil as being too high, and by NYPSC as being too low. We have examined the testimony regarding this matter and conclude that FPC had a substantial evidentiary basis from which it could conclude that the particular rates which it established should supply a reasonable floor on these charges. This answers Mobil's objection. As to NYPSC's contention that the allowance is not high enough, we only need point out that the established rates are merely "minimums". The pipelines are certainly free to bargain for higher rates if they wish.

This provision of Op: 598 is affirmed.

The Effective Date of New Gas Rates

FPC ordered, as part of the entire rate scheme, each producer in SLA to file certain data within 20 days from the date of Op: 598. It also provided that producers who filed within this 20 day period for increased rates could put these rates into effect 65 days from the date of FPC's order, as long as the rates comported with the provisions of their respective contracts, and fell below the ceilings established for the area. Any rate increase not filed within the 20 day period could not become effective until 90 days from the date of the filing. Both Amoco and Mobil suggest that in so ordering FPC has overstepped the bounds of its authority under § 4.

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[36] The minimum charges are .02¢/Mcf/mile for liquefiable hydrocarbons and 20¢/barrel for liquids. Significantly, in Order No. 449 (January 31, 1972) FPC adopted these same rates in its Docket No. R-338 directed solely to this matter.

The applicable provisions of § 4 state:

> "*Unless the Commission otherwise orders*, no change shall be made by any natural gas company in any such rate * * * except after 30 days' notice to the Commission and to the public." (Emphasis added)

§ 4(d) of the NGA, 15 U.S.C.A. § 717c(d).

The thrust of the argument is that FPC's authority to delay the effectiveness of rate filings under § 4 only applies *before* a given rate has been determined to be "just and reasonable". But this clearly ignores the first phrase of § 4(d). Under this phrase, FPC has the authority to "otherwise order". And, in adopting the entire settlement proposal as its decision on the merits, FPC did so order. Because we are unable to state to what extent FPC might have altered or modified the effective date if it had dredged out all of the provisions of the rate scheme, we refuse to tamper with this administrative decision.[37]

In sum, we hold that Op: 598, now immutably dubbed as *SoLa II*, was fully supported by "substantial evidence on the record as a whole".

VII. An Anchor-to-Windward

There has never been unanimous support in any forum for FPC regulation of natural gas rates by way of the area rate method. Indeed, when the Supreme Court first sanctioned FPC's abandonment of the individual producer cost-of-service method of rate calculation in *Phillips II*, *Wisconsin* v. *FPC*, 1963, 373 U.S. 294, 315, 83 S.Ct. 1266,

[37] Mobil contends that FPC's capitulation on the effective date in both the Texas Gulf Coast Area Rate Proceeding, Op: 595, and Other Southwest Area Rate Cast, Op: 607, precludes it from adhering to its original order in Op: 598. Of course, one factor which differentiates the present case from those is that here FPC adopted the total rate scheme proposed by the parties. But we do not want to over-emphasize this element, for we hold that it is within the bounds of administrative discretion for FPC to make its adjustments as it views each separate case.

——, 10 L.Ed.2d 357, ——, the vote was five to four with Justice Clark filing a lengthy dissent which he introduced with the following observation: "The Sisyphean labors of the Commission continue as it marches up the hill of producer regulation only to tumble down again with little undertaken and less done." When the Court later specifically upheld the area rate method in *Permian* Justice Douglas filed a dissenting opinion to demonstrate some of the specific economic problems which area ceilings based upon the costs of the non-existent "average" producer might have when applied to various individual producers. Broadly condemning a system based on averages with no assurance that they were "typical" or "representative" data, he said:

> "The average per capita income of a Middle East kingdom is said to be $1800 a year. But since one man—or family—gets most of the money, $1800 a year describes only a mythical resident of that country."

390 U.S. at 835, 88 S.Ct. at ——, 20 L.Ed.2d at 375.

Nevertheless, the thrust of *Permian* is that FPC is free to make an administrative determination which it believes will foster the most efficient and thorough regulation of natural gas rates. The method which it chose in *Permian* and *SoLa I* and *II* is the area rate method.

But FPC is not committed solely to that approach. It, too, realizes that individual circumstances may often warrant specialized relief. In Order No. 455, issued in Docket No. R-441 on August 3, 1972, FPC promulgated 18 C.F.R. § 2.75, "Optional Procedure for Certificating New Producer Sales of Natural Gas".[38] Under this new

[38] Order 455 is now pending judicial review in the D.C. Circuit, Moss v. FPC, [No. 72-1837] and APGA v. FPC. [No. 72-1846]. Accordingly we express no opinion as to its validity.

This result was achieved through FPC's rule-making powers, and without the extensive hearings with which it has previously

procedure contracting parties may seek a permanent certificate of public convenience and necessity for the sale of post-April 6, 1972, gas at rates in excess of the applicable area rate ceiling and not subject to refund, see *FPC* v. *Sunray DX Oil Co.*, 1968, 391 U.S. 9, 88 S.Ct. 1526, 20 L.Ed.2d 388, if FPC determines that rate to be in the public interest.

One cannot read Order 455 without recognizing that FPC is struggling to provide a sufficiently flexible administrative structure to accommodate all producers of natural gas, and vicariously, the public demand. FPC is quick to point out that the procedure adopted in Order 455 is meant merely to supplement, not supplant, the area rate method. But it is a comforting reassurance to a court that has demonstrated so many times its inability to review rate determinations with infallible omniscience to know that there are alternative methods by which producers who are unable to exist in the economic clime of the area rate ceilings may get administrative consideration of the merits of their claims.

Order 455 is limited to very "new", i.e. post-April 3, 1972, gas. But it is not the only method available. FPC informs us that producers may also seek redress by (i) directly petitioning FPC to make a special allowance for a deviation from area ceilings as contemplated by *Permian*, see e.g., George Mitchell and Associates, Op: 649, "Opinion and Order Granting Special Relief and Terminating Proceedings", —— F.P.C. —— (February 21, 1973); (ii) filing for the certification of emergency purchases under the provisions set forth in Order 431, 45

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been encumbered. FPC is also using this abbreviated type proceeding for some of its area rate determinations. See Phillips Petroleum Co. v. FPC, 10 Cir., 1973, —— F.2d —— [No. 71-1659, February 20, 1973], where the Tenth Circuit approved the procedure.

F.P.C. 570 (April 15, 1971);[39] (iii) applying for an initial certification of a sale in excess of area rates, but subject to the later determination of area rates under the terms of the Statement of Policy, ¶ 12, in Docket No. R-389A, 35 Fed. Reg. 11638 (July 17, 1970); or (iv) any one of several other methods.[40]

The presence of these alternatives should serve to alleviate any problems engendered by the area approach. They certainly provide great comfort to us in our role as a court compelled to review the area rate determinations, and furnish us with additional support for our decision today.

Op: 598 is sustained in full.

ENFORCED.

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[39] There have been 62 separate certifications of sales committing a total of about 500 billion cubic feet of gas to the interstate market at rates ranging from 26 to 40¢/Mcf since this Order 431 procedure was authorized by FPC. In Order 455, FPC suggested that one of the main problems with the Order 431 procedure was that it delayed administrative action until an emergency situation had been reached. The optional procedure established by Order 455 would hopefully solve the problem in its incipiency.

[40] FPC has continued, for example, to exempt "small producer sales" from area rate regulation. See Order 428, 45 F.P.C. 454 (1971).

We are very impressed by the pragmatic and flexible manner in which FPC has approached natural gas rate regulation as a whole.

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

OFFICE OF THE CLERK

Edward W. Wadsworth
Clerk

600 Camp Street
New Orleans, La. 70130

April 20, 1973

Mr. Maurice Moe
Editorial Counsel
West Publishing Co.
St. Paul, Minn. 55102

Re: No. 71-2761—Placid Oil Company, et al v. FPC
(Slip opinion dated April 16, 1973)

Dear Mr. Moe:

Prior to final publication, please make the following corrections in the opinion in the above cause:

1) On page 2, the ninth line from the top of the first full paragraph, "*Phillips I*" should be changed to "*Phillips II*";

2) On page 3, at the end of footnote 3 add "Subsequent to the printing of this opinion the Court became aware that Op: 658 partially setting rates for the Rocky Mountain Area was issued on April 11, 1973. FPC has apparently also decided to issue national rates which pre-empt these area determinations under its rule-making power in its Docket No. R-389B. See Foster Associates Report No. 891 (April 12, 1973)." The material above goes after the last sentence of footnote 3, and is not a new paragraph;

3) On page 5, on the second line of the footnote, the word "casinghead" should be one word, instead of a hyphenated word;

4) On page 5, on the sixth line of the footnote, the word "product" should be changed to "by-product";

5) On page 15, the first word of the first full paragraph "It" should be changed to "FPC";

6) On page 31, the fourteenth line from the top of the page, correct the spelling of the word "these";

7) On page 36, footnote 20 should be corrected to read "APGA does contend that, by relying too heavily on industry-supplied AGA data, FPC has failed to follow the mandate of this Court in *SoLa I* to premise its future rate-making on supply and demand. As we demonstrate in note 13 *supra*, APGA's notion that there is no supply shortage is blindly unrealistic.";

8) On page 53, the seventh line from the top of the page, the sentence beginning at the end of the line should be changed to read "Taking the effect of the refund credit as a whole, we find that *Hugoton-Anadarko* is authority for the proposition that FPC may tailor its refund orders to the particular needs of the industry in a given area.";

9) On page 54, the fourteenth line from the top of the page, in the blank between "see notes" and "*supra*" insert "19 & 23"; also omit the blank on the next line down;

10) On page 59, the third line from the top of the page, in the brackets put "No. 71-2032, March 13, 1973";

11) On page 60, the eighth line from the top of the page, change the sentence to read "It is a lump sum sale of in-place reserves.";

With kind appreciation, I am

Very truly yours,

EDWARD W. WADSWORTH
Clerk

By /s/ Susan LeBrun
Deputy Clerk

/sbl

cc: ALL COUNSEL OF RECORD

APPENDIX D

Natural Gas Act, Sections 4, 5, and 19(b).

The Natural Gas Act, 52 Stat. 821 (1938), as amended, 15 U.S.C. § 717 *et seq.*:

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company

in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the pro-

ceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. [52 Stat. 822 (1938); 76 Stat. 72 (1962); 15 U.S.C. § 717c]

SEC. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice,

or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

(b) The Commission upon its own motion, or upon the request of any State commission, whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transportation of natural gas by a natural-gas company in cases where the Commission has no authority to establish a rate governing the transportation or sale of such natural gas. [52 Stat. 823 (1938); 15 U.S.C. § 717d]

* * * *

SEC. 19. (b) Any party to a proceeding under this act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commis-

sion shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in [former] sections 239 and 240 of the Judicial Code, as amended (U.S.C., title 28, sec. 1254).

* * * *

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-437

MOBIL OIL CORPORATION,
Petitioner,

v.

FEDERAL POWER COMMISSION

SUPPLEMENT TO APPENDICES TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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September 6, 1973

NOTE: The following Synopsis is printed herewith, preceding the opinion, as a convenience for readers, and is not part of the opinion.

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 71-1828

TEXAS GULF COAST AREA
NATURAL GAS RATE CASES *

Decided August 24, 1973

The Federal Power Commission's order establishing "just and reasonable rates" for interstate sales of natural gas from the Texas Gulf Coast producing area has these central features: (a) a schedule of base area rates predicated on costs of service but including upward adjustments intended to elicit increased gas supplies for the interstate market; and (b) a system of incentives, also designed to elicit increased supplies, including escalations in the flowing gas rates and credits on producers' existing refund obligations, both contingent on dedication of new supplies to the interstate market.

A. With respect to the base area rates, *Held:* The Commission failed to state reasons or findings, based on substantial evidence, sufficient to support the reasonableness of non-cost upward adjustments in the otherwise cost-premised base area rates or to relate those adjustments to the causes and dimensions of the supply problem. (Opinion of Chief Judge Bazelon at 86ff; Judge Leventhal dissents at 38ff.)

B. With respect to the incentive provisions, *Held:* The requirement of "substantial evidence" in § 19 of the Natural Gas Act reflects a congressional intent to limit agency's de-

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* No. 71-1828, Public Service Commission for the State of New York v. Federal Power Commission; and other cases consolidated therewith.

terminations to record evidence; the Commission may not rely on record evidence adduced in another proceeding, which petitioners here have been given no opportunity to confront, to support results it has reached in this proceeding. (Opinion of Judge Leventhal at 47-53). The Commission failed to provide findings and reasons sufficient to support the non-cost incentive provisions, particularly since its order demonstrates a lack of reasoned analysis of the relationship between the goal of increased supplies and either the concept or amounts of the incentives, of the discriminatory effects that the incentives may have among both producers and consumers, and of the relative merits of possible alternative approaches. (Opinion of Judge Leventhal at 53-70).

C. In rejecting the remainder of the challenges to the order, *Held:* 1. The Commission did not err in continuing to employ cost calculations as predicates for establishing base area rates, since such calculations serve as benchmarks for determining just and reasonable rates and the producers fail to show that any alternative, non-cost methodology is available that is reliable and would not amount, in effect, to deregulation. (Opinion of Judge Leventhal at 22-27). 2. The Commission did not err in calculating flowing gas costs, since (a) its failure to make updated findings on each cost element of the flowing gas rate base was not shown to have led to an unjust and unreasonable result; (b) the Commission made adequate findings that the rates cover revenue requirements; and (c) the rate of return allowed for flowing gas need not be equal to that allowed for new gas. (Opinion of Judge Leventhal at 27-31). 3. The producers fail to show that the Commission's calculations of successful well costs, exploration and development costs, and royalties, or its choice of price adjustment for varying BTU content of new and flowing gas, are unsupported by the record, arbitrary, or vitiate the justness of the Commission's results. (Opinion of Judge Leventhal at 31-35). 4. The division date established between flowing and new gas is not so unreasonable as to warrant reversal, given, in particular, the expectation of higher rates that previous Commission orders had generated among producers, nor did the Commission exceed its authority in imposing a moratorium until January 1, 1976, on price increase filings. (Opinion of Judge Leventhal at 35-38).

Remanded.

Notice: This opinion is subject to formal revision before publication in the Federal Reporter or U.S.App.D.C. Reports. Users are requested to notify the Clerk of any formal errors in order that corrections may be made before the bound volumes go to press.

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

TEXAS GULF COAST AREA
NATURAL GAS RATE CASES

No. 71-1828

PUBLIC SERVICE COMMISSION FOR THE STATE OF NEW YORK, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

INTERVENORS: ATLANTIC RICHFIELD CO.; MOBIL OIL CORPORATION; THE UNITED DISTRIBUTION COMPANIES; ASSOCIATED GAS DISTRIBUTORS; CONTINENTAL OIL COMPANY; SUPERIOR OIL COMPANY; HUMBLE OIL AND REFINING CO.; AMERICAN PUBLIC GAS ASSOCIATION; SHELL OIL COMPANY; UNION OIL COMPANY OF CALIFORNIA; GULF OIL CORPORATION; TEXACO, INC.; GENERAL AMERICAN OIL COMPANY OF TEXAS; ASHLAND OIL INC.; FOREST OIL CORPORATION; CALLERY PROPERTIES, ET AL., INC.; SUN OIL COMPANY; STATE OF TEXAS; AMERADA HESS CORPORATION; MARATHON OIL COMPANY; SKELLY OIL COMPANY; CALIFORNIA COMPANY; PUENTICITAS OIL COMPANY; HUNT OIL COMPANY, ET AL; CITIES SERVICE OIL COMPANY; SOHIO PETROLEUM COMPANY; PHILLIPS

PETROLEUM COMPANY; TENNECO OIL COMPANY; BLANCO OIL COMPANY

No. 71-1836

MOBIL OIL CORPORATION, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

INTERVENORS: GULF OIL CORPORATION; SHELL OIL COMPANY; HUMBLE OIL AND REFINING COMPANY; SKELLY OIL COMPANY; PUENTICITAS OIL COMPANY; THE CALIFORNIA COMPANY; CITIES SERVICE OIL COMPANY, TEXACO INC.; ATLANTIC RICHFIELD CO; TENNECO OIL CO; PHILLIPS PETROLEUM CO

No. 71-1911

GULF OIL CORPORATION, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

INTERVENORS: THE CALIFORNIA COMPANY;

No. 71-1913

SOHIO PETROLEUM COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

THE CALIFORNIA COMPANY

GULF OIL CORPORATION, INTERVENORS

No. 71-1930

CONTINENTAL OIL COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

THE CALIFORNIA COMPANY

GULF OIL CORPORATION, INTERVENORS

No. 71-1988

HUMBLE OIL AND REFINING COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

INTERVENORS: CONTINENTAL OIL COMPANY; ASSOCIATED GAS DISTRIBUTORS; SUN OIL COMPANY; CITIES SERVICE OIL COMPANY; THE CALIFORNIA COMPANY; UNITED DISTRIBUTION COMPANIES

No. 71-1989

SHELL OIL COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

THE CALIFORNIA COMPANY

UNITED DISTRIBUTION COMPANIES, INTERVENORS

No. 71-1990

THE SUPERIOR OIL COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

THE CALIFORNIA COMPANY

CITIES SERVICE OIL COMPANY

UNITED DISTRIBUTION COMPANIES, INTERVENORS

No. 71-1991

THE CALIFORNIA COMPANY,
A DIVISION OF CHEVRON OIL COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

PENNZOIL PRODUCING COMPANY, INTERVENOR

No. 71-2015

TEXACO, INC., PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

THE CALIFORNIA COMPANY
GETTY OIL COMPANY, INTERVENORS

No. 71-2020

AMOCO PRODUCTION COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

THE CALIFORNIA COMPANY, INTERVENOR

No. 71-2025

AMERADA HESS COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

THE CALIFORNIA COMPANY, INTERVENOR

No. 71-2055

PHILLIPS PETROLEUM COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

THE UNITED DISTRIBUTION COMPANIES, INTERVENOR

No. 72-1071

HUNT OIL COMPANY, ET AL, PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT

Petitions for Review of order of the Federal Power Commission

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Peter H. Schiff, General Counsel, Public Service Commission for the State of New York, with whom *Joseph J. Klovekorn*, Staff Counsel, Public Service Commission for the State of New York and *Michael H. Rosenbloom* were on the brief, for petitioner in No. 71-1828.

Carroll L. Gilliam with whom *Tom P. Hamill* and *Philip R. Ehrenkranz* were on the brief for petitioners in No. 71-1836 and intervenor Mobil Oil Corporation in No. 71-1828.

John R. Rebman, with whom *Martin E. Erck* was on the brief, for petitioner in No. 71-1988 and intervenor Humble Oil and Refining Company in Nos. 71-1828 and 71-1836 also argued for certain other producer petitioners.

George B. Miclum, III, with whom *James L. McHugh, Jr.,* was on the brief for intervenor, Blanco Oil Company, in No. 71-1828.

Thomas G. Johnson with whom *Dan A. Bruce* was on the brief for petitioner in No. 71-1989 and intervenor Shell Oil Company in No. 71-1828 and 71-1836, also argued for certain other producer intervenors.

Michael J. Manning, Attorney, Federal Power Commission with whom *Gordon Gooch,* General Counsel, *Lee E. Forquer,* Solicitor and *George W. McHenry, Jr.,* First Assistant Solicitor, Federal Power Commission were on the brief for respondent. *J. Richard Tiano,* First Assistant Solicitor Federal Power Commission at the time the record was filed, also entered an appearance for respondent.

John Frederick Moring with whom *John E. Holtzinger, Jr.,* was on the brief for intervenor, Associated Gas Distributors in Nos. 71-1828 and 71-1988.

Edwin S. Nail was on the brief for petitioner in No. 71-2025 and intervenor Amerada Hess Corporation in No. 71-1828.

W. H. Emerson was on the brief for petitioner in No. 71-2020.

Tom Burton was on the brief for petitioner in No. 71-1930 and intervenor Continental Oil Company in No. 71-1828 and 71-1988.

Justin R. Wolf and *Paul W. Wright* were on the brief for petitioner in No. 71-1991 and intervenor, The California Company.

Warren M. Sparks was on the brief, for petitioner in No. 71-1911 and intervenor in Gulf Oil Corporation.

Robert W. Henderson and *Paul W. Hicks* were on the brief for petitioners in No. 72-1071.

Kenneth Heady was on the brief for petitioner in No. 71-2055 and intervenor Phillips Petroleum Company in Nos. 71-1828 and 71-1836.

Richard F. Remmers was on the brief for petitioner in No. 71-1913 and intervenor Sohio Petroleum Company in No. 71-1828.

H. W. Varner and *Frank P. Saponaro, Jr.,* were on the brief for petitioner in No. 71-1990 and intervenor Superior Oil Company, No. 71-1828.

J. Donald Annett, Kirk W. Weinert and *C. Fielding Early, Jr.,* were on the brief for petitioner in No. 71-2015 and intervenor, Texaco, Inc., in No. 71-1828 and 71-1836.

Tilford A. Jones and *William A. Mogel* were on the brief for intervenor United Distribution Companies in No. 71-1988, 71-1989 and 71-1990.

Charles F. Wheatley, Jr., was on the brief for intervenor, American Public Gas Association in No. 71-1828.

John T. McMahon was on the brief for intervenor Ashland Oil Inc. in No. 71-1828. *Richard F. Generally* also entered an appearance for intervenor Ashland Oil Inc., in No. 71-1828.

Charles E. McGee was on the brief for intervenor Atlantic Richfield Company in No. 71-1828.

Richard F. Generally was on the brief for intervenors, Callery Properties, Inc., F. A. Callery Inc., Forest Oil Corporation, General American Oil Company of Texas in No. 71-1828.

Sam Riggs, Jr., was on the brief for intervenor Cities Service Oil Company in No. 71-1828.

William A. Sackmann was on the brief for intervenor Marathon Oil Company in No. 71-1828.

Cecil N. Cook was on the brief for intervenor Puenticitas Oil Company in No. 71-1828 and 71-1826.

Ronald J. Jacobs was on the brief for intervenor, Skelly Oil Company in No. 71-1828 and 71-1836.

Stanley M. Morley and *Louis Flax* were on the brief for intervenor Sun Oil Company in No. 71-1828.

John E. Watson was on the brief for intervenor, Tenneco Oil Company in Nos. 71-1828 and 71-1836.

Dee H. Richardson was on the brief for intervenor, Union Oil Company of California in No. 71-1828.

Noble John Allen, Jr., entered an appearance for intervenor, Union Oil Company of California in No. 71-1828.

Francis H. Caskin entered an appearance for intervenor Sun Oil Company in No. 71-1828 and 71-1988.

John S. White entered an appearance for intervenor, Marathon Oil Company in No. 71-1828.

Bernard A. Foster, III, entered an appearance for intervenor, Skelly Oil Company in No. 71-1828 and 71-1836.

Graydon D. Luthey entered an appearance for intervenor Cities Service Oil Company in No. 71-1828 and 71-1836.

Lewis J. Ottaviani entered an appearance for intervenor, Phillips Petroleum Company in No. 71-1828 and 71-1836.

William R. Choate entered an appearance for intervenor Pennzoil Producing Company in No. 71-1991.

Robert J. Haggerty entered an appearance for intervenor, Getty Oil Company intervenor in No. 71-2015.

Before BAZELON, *Chief Judge,* LEVENTHAL, *Circuit Judge,* and RICHEY,* *United States District Judge of the District Court for the District of Columbia.*

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* Sitting by designation pursuant to 28 U.S.C. § 292(a) (1970).

Opinion filed by *Circuit Judge* LEVENTHAL, in which *Chief Judge* BAZELON and *District Judge* RICHEY concur, except as to Part VI.

Opinion filed by *Chief Judge* BAZELON, in which *District Judge* RICHEY concurs. *Circuit Judge* LEVENTHAL dissents, for the reasons set forth in part VI of his opinion.

PER CURIAM: These petitions for review challenge the validity of the Federal Power Commission's order, establishing "just and reasonable rates," under Sections 4 and 5 of the Natural Gas Act, for sales of natural gas in interstate commerce from the Texas Gulf Coast producing area. The court remands the order to the Commission for further consideration.

The order is composed of two basic parts. The first is the schedule of base area rates. With respect to this, Chief Judge Bazelon files an opinion for the court, beginning at page 86 *infra*. Judge Richey concurs in this opinion. Judge Leventhal dissents for the reasons stated in Part VI of his opinion, pages 38 to 47 *infra*.

With respect to the second basic part of the order—the system of incentives—and the remainder of the issues in this case, Judge Leventhal files an opinion in which Chief Judge Bazelon and Judge Richey concur. Thus, Parts I through V, pages 10 to 38 *infra*, and Parts VII and VIII, pages 47 to 72 *infra*, of Judge Leventhal's opinion also constitute the opinion of the court.

So ordered.

LEVENTHAL, *Circuit Judge*: In the Order before us for review in this case,[1] establishing "just and reasonable rates"

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[1] Opinion No. 595, Area Rate Proceeding, et al. (Texas Gulf Coast Area), Docket No. AR64-2, et al., 45 FPC 674 (May 6, 1971); Opinion No. 595-A, Area Rate Proceeding, et al., Order Modifying and Clarifying Prior Order and Denying Rehearing, 46 FPC 827 (October 18, 1971).

under Sections 4 and 5 of the Natural Gas Act,[2] the Federal Power Commission has provided both base rates and incentive provisions to govern interstate sales of natural gas produced in the Texas Gulf Coast Area. This area consists of 54 Texas counties stretching along the Gulf of Mexico from Louisiana to Mexico. It also includes over 3,560 square

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[2] Section 4.(a) of the Natural Gas Act, 15 U.S.C. § 717c, provides:

> All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared unlawful.

Section 5.(a), 15 U.S.C. § 717d, provides:

> Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural-gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

miles of underwater continental shelf within state jurisdiction and 20,000 square miles of underwater shelf within Federal domain.[3] The FPC's approach of fixing gas producer rates by producing area rather than on a company by company basis was approved by the Supreme Court in the *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).[4] The order in this area rate proceeding contains unusual features, which are challenged in the several petitions for review filed pursuant to section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r. We shall first outline these features. The reasoning the FPC used in arriving at its results will be examined subsequently, in considering the challenges lodged against different aspects of the Order.

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[3] The area was defined in the FPC order commencing this proceeding, Docket No. AR64-2, 28 Fed. Reg. 12,645 (Nov. 27, 1963).

[4] The background of area rate regulation is well summarized in Southern Louisiana Area Rate Cases (Austral) v. FPC, 428 F.2d 407, 415-18 (5th Cir. 1970), *cert. denied*, Municipal Distributor Group v. FPC, 400 U.S. 950 (1970). Currently proceedings are pending before the Commission in Permian II, Docket No. AR70-1; the decision of the Presiding Examiner issued on December 20, 1972. Since *Austral* and *Permian*, Hugoton-Anadarko Area, Docket No. AR64-1, Opinion No. 586, 44 FPC 761 (1970), was affirmed by the Ninth Circuit in California v. FPC, 466 F.2d 974 (1972); Rocky Mountain Area, Order No. 435, Establishing Initial Rates, 46 FPC 68 (1971), was affirmed by the Tenth Circuit, *sub nom.* Phillips Petroleum Co. v. FPC, Slip Opinion No. 71-1659 (Feb. 20, 1973); Southern Louisiana Area II, Opinion No. 589, 46 FPC 86 (1971), was affirmed by the Fifth Circuit *sub nom.* Placid Oil Co. v. FPC, Slip Opinion No. 71-2761 (April 16, 1973); and Other Southwest Area, Opinion No. 607, 46 FPC 900 (1971), was affirmed by the Fifth Circuit *sub nom.* Shell Oil Co. v. FPC, Slip Opinion No. 72-1114 *et al.* (June 8, 1973). No appeal was taken in Appalachian and Illinois Basin Area, Docket No. R-371, Opinion No. 411, 44 FPC 1112 (1970).

I. PROVISIONS OF THE FPC ORDER

The centerpiece of the FPC Order prescribing rates—a term used, for convenience, to identify the ceilings put on producers—is the provision for the Base Area Rates. This consisted of what is referred to as a three-vintage maximum rate system, with different maximum prices applied to casinghead and gas-well gas, depending on the date on which the producers contracted to deliver the gas. The prices per Mcf, determined on the basis of cost and non-cost factors, depend on the three vintage periods of the contract, and then on the time of delivery, as follows:[5]

(1) Gas sold under contracts dated prior to January 1, 1961:
   (i) 15.0 cents prior to January 1, 1965
   (ii) 17.0 cents from January 1, 1965 to September 30, 1968
   (iii) 19.0 cents from October 1, 1968 to September 30, 1973
   (iv) 20.0 cents on and after October 1, 1973

(2) Gas sold under contracts dated on or after January 1, 1961, and prior to October 1, 1968:
   (i) 18.0 cents prior to January 1, 1965
   (ii) 18.5 cents from January 1, 1965 to September 30, 1968
   (iii) 19.0 cents from October 1, 1968 to September 30, 1973
   (iv) 20.0 cents on and after October 1, 1973

(3) Gas sold under contracts dated on or after October 1, 1968:
   (i) 24 cents prior to October 1, 1973
   (ii) 25 cents on and after October 1, 1973

In sum, three "division dates" for contracts are set: 1961, 1968 and post 1968. Gas under contracts in each of these periods is given a different maximum price, depending on the delivery date. Thus the above table means that if gas

[5] 45 FPC at 718.

was contracted for prior to 1961 and delivered in 1965, the maximum price would be 17¢ per Mcf. These base area rates were combined with a moratorium provision on filing increases above the applicable area rates, until January 1, 1976.[6]

The Commission also found that "The present critical shortage of all forms of energy in the United States and the anticipated rapid growth of demand for natural gas, in particular, makes it imperative to provide incentives to find gas and dedicate that gas to the interstate market."[7] In view of the critical shortage, the FPC established two incentives:[8]

> (1) a credit of one cent per Mcf toward discharge of [a producer's] refund obligations for each additional Mcf of gas hereafter dedicated to interstate commerce prior to January 1, 1976, by an individual producer;
>
> (2) increases in the area rates of gas under contracts dated prior to October 1, 1968, from the time prior to January 1, 1976, that the independent producers as a group have dedicated to interstate commerce more than a specific amount of additional gas from the area.

In regard to the refund provision, the FPC Order provides that reserves dedicated for refund reduction, under paragraph (1), may not be counted toward new dedications needed to make the contingent escalation operative under paragraph (2).

The contingent escalation in price applies only to increase the base area rates for gas sold under contracts prior to October 1, 1968, and the increases are made on a group basis; after a gross amount of new dedications are made,

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[6] *Id.* at 720.

[7] *Id.* at 709.

[8] *Id.* at 710.

all producers with pre-October 1, 1968 contracts receive an increase in price. The total new dedications needed and the corresponding increase are as follows:[9]

Total New Dedications	*Base Area Rate Increase*
4,000,000,000 cubic feet	.5 cent per Mcf
6,000,000,000 cubic feet	additional .5 cent per Mcf
10,000,000,000 cubic feet	additional 1.0 cent per Mcf

II. SUPPLY SHORTAGE

Since many features of the FPC Order in this case, particularly the incentive provisions, concern the supply shortage of natural gas, some assessment of the record evidence on this matter should serve as a backdrop to the contentions of the parties.

The Commission found that the demand for natural gas was expected to increase faster than the current rate of production. Total demand for natural gas is expected to reach 28.1 trillion cubic feet by 1975, requiring an annual level of domestic production of 27.2 trillion.[10]

The Examiner, the Commission explained, had underestimated the possible shortage of supply in arriving at his price proposals. Thus, his opinion indicated that finding-to-production (F/P) ratios would be above unity in the foreseeable future; yet the Commission found that the F/P ratio has been below unity since 1967, and dropping.

A second indicator of supply, reserves-to-production, also

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[9] *Id.* at 719.

[10] *Id.* at 687. This estimate was based on a study of the Future Requirements Committee, "Future Gas Requirements for the United States by 1975" (Vol. 3, 1969). Also, *see generally* Federal Power Commission, Natural Gas Supply and Demand 1971-1990, Staff Report No. 2 (1972); Federal Power Commission, A Staff Report on National Gas Supply and Demand (1969).

indicated a shortage. The (R/P) ratio for interstate pipelines in the Texas Gulf Coast Area had declined from 14.9 in 1964 to 11.5 in 1969.[11] Less than 18% of the 1969 interstate production came from new sources of supply, reported in the six-year period commencing in 1964. The Commission found that if demands from the Texas Gulf Coast area during the next five years were to be satisfied, it was essential that jurisdictional sales increase from their 1965-1969 volume of 8 trillion cubic feet to 12.5 trillion cubic feet cumulatively for the period of 1971-1975.[12] The Commission believed that to achieve this desired level, its goal for dedications of new reserves from the Texas Gulf Coast to the interstate market should be 20 trillion cubic feet during the 1971-1975 period.[13]

The supply shortage of interstate gas reflects, *inter alia*, the fact that intrastate sales of natural gas are unregulated by the FPC.[14] The demands from the intrastate market, particularly in the consuming states of the Texas Gulf Coast, increased 44% from 1963 to 1969, while interstate production was constant.[15] Taking into account the fact that intrastate prices were often higher than those in interstate sales, due to the unregulated nature of the former market, the FPC stated it had to consider prices which would make interstate demands more competitive.

Not only was there a deteriorating reserves-to-production ratio in the area, but the absolute number of proven reserves available for interstate sale was low—about 1 trillion, as compared with the 20 trillion cubic feet of new

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[11] FPC S-207, The Gas Supplies of Interstate Natural Gas Pipeline Companies (1969), Table 11, at 29.

[12] 45 FPC at 689.

[13] *Id.*

[14] 15 U.S.C. § 717(b).

[15] 45 FPC at 689.

reserves the Commission wants dedicated to the interstate market in the 1971-75 period.[16] The supply shortage was the reason given by the Commission in setting its base prices, and in devising its incentive provisions in the proposed rate order.

III. STANDARDS OF JUDICIAL REVIEW

We turn to the Permian Basin Area Rate Case, 390 U.S. 747 (1968), to lay the foundation for the standards of judicial review to be used in assessing the merits of the challenges before us. Generally, we must be mindful of our duty to sustain Commission rate levels which are within a "zone of reasonableness."[17] "A presumption of validity therefore attaches to each exercise of the Commission's expertise, and those who would overturn the Commission's judgment undertake 'the heavy burden of making a convincing showing that it is invalid because it is unjust and

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[16] Data on Total Proven Reserves and Reserves Available for sale by large producers was compiled in Docket No. R-405, a proposed Rulemaking with respect to developing Emergency Plans in connection with reliability of electric and gas service in the United States. Data was compiled on the basis of a Commission Questionnaire. Total Proven Reserves are "The current estimated quantity of natural gas which analysis of geologic and engineering data demonstrate with reasonable certainty to be recoverable in the future from known oil and gas reservoirs under existing economic and operating conditions." Proved Natural Gas Reserves Available for Sale are "those which are not covered by gas purchase contracts and are not reserved for direct industrial contracts, company use-warranty or company use-fuel and feedstock." As of December 31, 1969, Total Proven Reserves, as reported by the American Gas Association, were approximately 67 trillion cubic feet. As of December 31, 1969 Large Producers Reserves Available for sale were approximately 1 trillion cubic feet, and as of October 1, 1970, .7 trillion.

[17] 390 U.S. at 767.

unreasonable in its consequences'." [18] These standards, as applied to a particular rate order are not a carte blanche for Commission discretion. As Justice Harlan, writing for the majority in *Permian*, made clear, these broad principles could further be concretized as follows: [19]

> [The] responsibilities of a reviewing court are essentially three. First, it must determine whether the Commision's order, viewed in light of the relevant facts and of the Commission's broad regulatory duties, abused or exceeded its authority. Second, the court must examine the manner in which the Commission has employed the methods of regulation which it has itself selected, and must decide whether each of the order's essential elements is supported by substantial evidence. Third, the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and forseeable.

Above all, the Court pointed out that "[j]udicial review of the Commission's orders will therefore function accurately and efficaciously only if the Commission indicates fully and carefully the methods by which, and the purposes for which, it has chosen to act, as well as the consequences of its orders for the character and future development of the industry." [20]

Most of the challenges to the Commission Order in this case involve issues relating to the inclusion of non-cost factors in pricing which are justified on the basis of the shortage of supply. While the task of justifying price methods which depart from pure costs poses difficult problems, due to the difficulty in understanding demand and supply

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[18] *Id.*

[19] *Id.* at 791-92.

[20] *Id.*

elasticities of natural gas,[21] this state of the art cannot be used as an excuse to offer no reasons for adopting these measures, or to supply reasons which have no basis in evidence and underlying reasoning. Whatever the problems of limitations on available knowledge, the Commission is under a duty to apply what knowledge is available, with a bona fide effort to identify both the scope and limitations of available knowledge, and the Commission's pertinent reasoning.

This opinion is organized as follows: In Part IV, we summarize the issues presented. In Part V, we examine producers' challenges to the general methodology, principally attacking the use of cost based methodology, and specific challenges of particular cost items, as well as other challenges to the rate structure. In Part VII we examine the validity of the Commission's use of non-cost based incentives, contingent escalation and refund "work-off", in the rate structure.

IV. THE SCOPE OF ISSUES AND THE POSITIONS OF THE PARTIES

The Order has been challenged from a multiplicity of points of view.[22] We here set forth a brief overview of

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[21] *See, e.g.*, Southern Louisiana I, Initial Decision of the Presiding Examiner, 40 FPC 703, 847-872 (1968); Opinion of the Commission, No. 546, 40 FPC 530, 625-26 (1968); *Austral, supra*, 428 F.2d at 436 n. 91.

[22] In briefs and argument before this court, Associated Gas Distributors support the position of the Commission in its entirety. New York Public Service Commission takes the position that the prices in the rate order are high enough, but opposes the Commission on other features of the order, including the non-cost incentives. The producers take various positions. Some, such as Humble Oil, argue that the prices are not high enough, but support the Commission's action

the disparate contentions. Subsequently we shall examine the challenges seriatim.

The rate structure has been attacked by the parties on a number of grounds: (1) the adoption of a cost-based pricing method is an inadequate response to the gas shortage, and prices on gas were set too low; (2) certain specific elements in the cost-derived prices were unreasonable; (3) the adoption of the moratorium in light of the shortage was unreasonable; and (4) the division date for new gas prices, October 1, 1968 was unreasonable. This last contention is made by the New York Public Service Commission (hereafter "New York"); the others are presented by producer petitioners.

As will appear from the opinion of Chief Judge Bazelon, the majority of the court construes the applications for rehearing and the petitions for review filed by both the Producers and Public Service Commission of the State of New York as challenging the base rate structure on an additional ground: that, assuming a cost premise for rates, the upward adjustments in the FPC's determination of costs and in its choice of rate from within the variable range of costs were not shown to be rationally related to the supply problem, either in concept or in amount.

Petitioner Blanco Oil Company raises a distinct issue which we shall consider in a separate opinion.[23]

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on incentives. Others, such as Mobil, argue for higher prices but oppose the use of incentives. Still other producers, such as Blanco, attack the effect of the order on outstanding refund obligations. Following the suggestion of the Supreme Court in *Permian*, 390 U.S. at 766 n. 32, counsel, upon invitation of this court, engaged in a pre-argument conference, in which significant efforts were made to focus and consolidate argumentation with a view to clarifying the positions of various parties on the issues involved in this case.

[23] No. 71-1970, Blanco Oil v. F.P.C.

Challenges to the incentive provisions of the Order—the contingent escalation of rates on flowing gas, and the provision allowing credits on existing refund obligations—have been made, on different grounds, by New York and by producers.

The contingent escalations are claimed by New York to discriminate against new entrants who will not receive the gain realized by old producers on gas already under contract. Old producers without refund liability, such as Mobil Oil, contend that they are subject to unreasonable discrimination because their dedication of new reserves will earn escalations for the entire industry, while other producers, with refunds, will both get an individual benefit from their dedications, by reducing their refund obligation, and share in the industry-wide dedications due to the efforts of other producers. It is further contended by New York that the bonus arrangement discriminates among pipelines and their customers. They allege that since the bonus for finding new gas is chargeable to gas consumers in proportion to the existing contracts of the pipelines upon which they rely, whether or not their pipeline actually secures any of the new dedications the bonus produces, the provision is unreasonable in failing to correlate higher consumer prices with additional new gas reserves secured by distributors.

As to the refund provision, certain producers contend that the reduction provision unfairly discriminates against those who have already made refunds, since they would have obtained reductions, if they had awaited the outcome of this proceeding. This argument is given another edge by the contention that the FPC Order, in effect, prefers the largest refund accumulators. New York argues that new entrants are also disadvantaged by the reduction measure, since they have no existing liabilities which can be reduced by new dedications. Further, New York contends that the provision discriminates against those owed past refunds,

since the FPC Order provides that only 50% of the new dedications used to discharge refund liability is required to go to those to whom the refunds were due.

We shall proceed to examine the various challenges.

V. CHALLENGES TO THE RATE STRUCTURE

A. *Challenges to General Methodology*

The Use of Cost Methodology

The most broad-based attack on the rate order challenges the use of cost methodology as an appropriate means of pricing gas under supply shortage conditions. It is argued that a price would be justified for new gas only if it would reasonably be expected to meet the supply objectives formulated by the Commission, and that the "new gas" price in this order does not accomplish this end. Producer petitioners adduce evidence that prices in the intrastate market, which competes with the demand of the interstate market, were as high as 30 cents on new contracts negotiated in the July 1, 1970 to 1971 period.[24] It is argued that the desired level of dedications to the interstate market of 20 trillion cubic feet needed to supply both the interstate and intrastate markets, is not a credible target in light of the fact that total reserve additions in the area for the entire ten-year period of 1961-1970 were only 28.7 trillion cubic feet.[25]

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[24] This information was taken from the record of another FPC proceeding and was not before the Commission at the time of their Opinion Nos. 595 and 595-A in the instant case, issued May 6 and October 18, 1971. *See* FPC Docket No. R-389A, Report of the Investigating Officer, November 8, 1971.

[25] *See* Brief For Indicated Producer Petitioners, Appendix D, The Railroad Commission of Texas, Annual Summary of Texas Natural Gas, for the division of gas between the intrastate and interstate markets. The 28.7 trillion cubic feet figure is taken from data compiled in Reports by the American

We are not prepared to follow these concerns to the point of overturning the methodology adopted by the Commission. First, the Commission did consider the effect that intrastate demand and prices would have on the supply available to the interstate market. The last data available to the Commission showed intrastate prices as high as 24.38 cents per Mcf for a contract dated in 1970. Whereas it is certainly true, as petitioners argue, that the Commission recognized that "the trend of intrastate prices is upward," [26] the general rate order does provide for a price increase to 25 cents for new gas in 1973.[27] Moreover, the contingent escalation provision means the effective yield on new gas contracts could be much higher, and may lead producers to make interstate contracts even though the price on such contracts will be below that available in the intrastate market.[28]

Second, we are not sure what the producers want to put in the place of the cost-based pricing used here by the Commission. Two other techniques of pricing, a discounted cash flow method and a price based on a theory of supply elasticity, formulated in an econometric model, were found by the Examiner to have serious predictive and reliability problems which had led to their rejection in other area proceedings. There is a burden on producers to show that alternative price techniques will lead to a "just and reasonable price."

Third, an analysis of the Commission's approach, contained in the Appendix to this opinion, shows the 24 cent price is not a purely cost-based price. The supply shortage

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Gas Association Committee on Natural Gas Reserves. *See* Brief of Indicated Producer Petitioners, Appendix C, updating Record evidence at 39,273.

[26] 45 FPC at 706.

[27] *See* text at note 5 *supra*.

[28] This point is more fully discussed at text and notes *infra*.

was reflected in the calculation of the variable ranges for each cost item, particularly the rate of return, and played a central role in the choice of the particular price within the range. Those who may be interested in this point can turn to the Appendix for amplification.

In its modification of the Examiner's methodology, the Commission did depart from the strict cost-based price system used in *Permian,* but this approach was suggested in the Supreme Court's opinion in *Permian,*[29] and specifically approved by the Fifth Circuit in its initial review of the Southern Louisiana Area Rate Proceeding.[30] The Commission used the strict cost-based price as an "anchor," following our reasoning in the context of individual ratemaking proceedings.[31]

The producers' major point was that they wanted the FPC to discard costs entirely, offering instead an "econometric" approach that would focus on the prices needed to bring out increments of supply. The FPC responded that not enough was known of the methodology of such an economic approach to make it a reliable means of regulation.

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[29] 390 U.S. at 815 & n.97.

[30] 428 F.2d at 426. The Fifth Circuit has reaffirmed its position that supply considerations can be broadly reflected in cost-based pricing in its recent opinion affirming the Commission's Southern Louisiana II opinion. Placid Oil Co. v. F.P.C., Slip Opinion No. 71-2761 (April 16, 1973). This approach was also approved in the Ninth Circuit's review of the Hugoton-Anadarko Area Rate Proceeding, 466 F.2d 974, 985 (1972).

[31] *See* City of Chicago v. FPC, 147 U.S.App.D.C. 312, 331, 458 F.2d 731, 750 (1971), *cert. denied,* 405 U.S. 1074 (1972); City of Detroit v. FPC, 97 U.S.App.D.C. 260, 230 F.2d 810 (1955), *cert. denied,* 352 U.S. 829 (1956). *Also see* Texaco, Inc. v. FPC, Slip Opinion No. 71-1560 (D.C.Cir., Dec. 12, 1972).

We cannot say this was error. In the last analysis, as we understand the matter, the underlying principle of economics requires that the determination of price needed to induce desired supply levels requires both some premise of profit necessary to spark management investment and effort, and also some determination or assumption of cost —whether of average cost, or the cost of the (bulk-line) increment of supply, etc.

Another option does remain—that of setting the price of natural gas at the market price, or of allowing the market price to govern the "just and reasonable price" of natural gas. A variant of this contention is the submission by the producers that in time of supply shortage, regulation for an area that serves not only an interstate market but also an (unregulated) intrastate market must set the regulated prices as high as the unregulated in order to prevent diversion to the intrastate market. However, so long as the legislature has assigned the agency the function of regulation of rates, it cannot legitimately execute that function in a fashion which, in fact, is tantamount to total deregulation or non-regulation.[32]

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[32] Texaco, Inc. et al. v. FPC, Slip Opinion No. 71-1560 et seq. (December 12, 1972). Judge Wilkey stated:

> Whatever the wisdom of the policy at this critical juncture of our national energy source problems, we cannot hold that *non*regulation is the statutory equivalent of regulation. Only Congress can knowingly prescribe nonregulation for small producers in lieu of the existing statutory scheme of regulation found by the Supreme Court in *Phillips* to be mandatory under the Natural Gas Act for all producers.

See also Other Southwest Area Rate Case, *supra* note 4, slip op. at 18.

We reaffirm the principle that regulation cannot be conducted on a premise tantamount to nonregulation. We are not called upon to consider whether, or to what extent, exemptions may be provided when accompanied by an express

Congress did not provide for agency action and court review as a charade.

The Commission has moved closer to this approach with Order 455,[33] adopting an "Optional Procedure for Certificating New Producer Sales of Natural Gas." This procedure provides that under § 7 of the Natural Gas Act, sellers can negotiate prices on contracts in excess of rates provided in the area rate system for:[34]

> A contract covering the sale of natural gas in interstate commerce [which] has been executed for gas produced from a well or wells commenced after April 6, 1972; *or* a contract covering the sale of natural gas in interstate commerce [which] has been executed for gas not previously sold in interstate commerce. . . .

Although we do not reach the merits of the legitimacy of the Optional Order 455,[35] giving sway to market forces,

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determination that they will, by removing an administrative burden from the pertinent agency, improve its capacity to further the legislature's regulatory objectives, and that the exemptions will not undercut the affirmative accomplishments of the regulatory program.

[33] The Order, as yet unreported, was issued on August 3, 1972, and was later supplemented by Order 455-A, denying applications for rehearing and stay and making certain clarifications, which issued on September 8, 1972.

[34] Order 455, mimeograph at 27.

[35] The question of the authority of the FPC to promulgate such a rule is before the court in Docket No. 72-1837, Moss v. FPC. We do note, however, that the questions involved in that case are not the same as those raised by Texaco v. FPC, *supra*, as that opinion clearly indicated in note 21, at page 12. Order 428, reviewed in *Texaco*, proposed no direct review of the negotiated contracts under Sections 4 and 7, and suggested that the contracts would be insulated from subsequent section 5 determination of "just and reasonable" rates. Order 455, on the other hand, contemplates Commission scrutiny of the negotiated rates. Presently, a number of contracts are being reviewed in Commission hearings.

we do note that its combination with the cost-based pricing system of the Rate Proceeding is significant in coping with objections of producers.[36]

B. *Calculation of "Flowing Gas" Costs*

The second major producer challenge concerns whether the price calculated for flowing gas is a "just and reasonable" maximum rate.

Claims of alleged failure to resolve disputed cost items

The producers object that the FPC failed to resolve disputed cost items. This contention is emmeshed in a stale data problem, caused here by the protracted nature of the proceedings. The producers object that, in updating the Examiner's cost data, the FPC failed to make updated findings on each cost element for the rate base on flowing gas. "Staleness of the record, however, is not itself a reason for reversal."[37] Moreover, the FPC concededly made an adjustment for the stale data problem; it updated, as a whole, the costs used by the Examiner, first by increasing his base price, and then by escalating this base price over time.[38] The producers argue that each cost item must be

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See, e.g., McCulloch Oil Corp., 38 Fed.Reg. 1600; Texas Production Co. et al., 38 Fed.Reg. 1765.

[36] The higher prices made possible by the Order, and the more significant departure from cost-based pricing, should elicit increased supply, if supply is at all price elastic. *See* E. Kitch, Field Market for Natural Gas, 11 J. Law and Economics 243, 277 (1968).

[37] *Austral, supra* note 4, 428 F.2d at 433.

[38] The Examiner, as indicated *supra* priced pre-1961 gas at 13.7 cents per Mcf, and post-1961 gas at approximately 18 cents. The Commission took, instead, a base price of 15 cents for pre-1961 gas, and an 18 cents base price for 1961-

updated separately. Whereas recalculation of individual cost items may be desirable, we see no showing that it has led to an unjust and unreasonable ceiling, to an "end result" contrary to the statute or Constitution.[39] The producers made no proffer that updating calculations made one by one would have led to a result significantly different from that reached by the FPC.

Claims of lack of findings that rates cover revenue requirements

Another contention of the producers, challenging the lack of a finding that prescribed rates will cover revenue requirements, fails for similar reasons. The Examiner found that a 13.4 to 13.7 cents per Mcf rate would cover costs. The FPC found that costs were higher and raised rates accordingly. This cost calculation of course included the profit element of "return" to the regulated producers. The Commission made a further allowance for the generation of capital for future exploratory efforts, both in setting the flowing gas base rate, and in the refund-forgiveness and contingent escalation provisions which supplement the rate structure. This goes to the substance of revenue requirements, and we cannot strain for formalities.

Return on flowing gas

The producers contend, in the alternative, that the FPC did not actually calculate a rate of return for flowing gas, and the rate of return should be 15%, the same rate allowed for new gas. The Examiner included a 10.5% rate of return in the costs used to calculate the 17.4 to 17.8 cents per Mcf

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1968 gas, but with escalations depending on date of delivery. *See* text at note 5 *supra*.

[39] FPC v. Hope Natural Gas, 320 U.S. 591, 603 (1944).

that became the basis of the price on flowing gas for the 1961-68 period.[40] In increasing the base price and allowing for escalations, the Commission, among other justifications, cited increased costs and the need for "a proper rate of return." 45 FPC at 707. It is, therefore, difficult to say whether the increased price was based on an increased rate of return or merely increased costs, or what proportion of each. Despite this problem, we can say that there is substantial evidence that the effective rate of return arrived at is at least 10.5%

Rate of return is calculated on the base of production investment. That base includes successful well costs, lease acquisitions and other production facilities, but the record makes it reasonably clear that the FPC did not consider these items, for flowing gas, to have increased significantly.[41]

The result of this analysis of the record (see note 41) establishes that the FPC's rate of return for flowing gas

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[40] 45 FPC at 832-835.

[41] Updated costs had been calculated for successful well costs in the context of the "new gas" rate. For new gas, the FPC set up a variable range of 2.70 to 4.10 cents per Mcf, as compared with the Examiner's figure of 2.77, and took the high side, out of concern with the need for increased supply. See 45 FPC at 704. But even a 2.70 cent cost, lower than the Examiner's calculation, would have been within the range. The impact of increases in costs subsequent to those put into the Examiner's calculation would be relatively modest as to "flowing gas". Drilling costs have already been incurred, the leases involved in the production of flowing gas have already been acquired. The last component of production investment (other than drilling costs and lease acquisition costs) is "other production facilities," a modest—almost de minimis—item, in the range of only .33 to .73 cents per Mcf even as to new gas. While an increase in production costs may have occurred for flowing gas, it plainly could not have materially increased the FPC's price on flowing gas.

was at least the 10.5% allowance used by the Examiner.[42] We turn to the alternative argument of the producers, that 10.5% is insufficient, and should be 15%, the same as rate of return allowed on new gas. We pass by both the prospect that the FPC's prices will yield a rate of return for flowing gas exceeding 10.5%,[43] and the circumstance that the Examiner used the same rate of return for both flowing and new gas. We see no immutable principle that the rate of return on both flowing and new gas must be equal. The time-honored standard for rate of return, formulated in Bluefield Water Works & Improvement Co. v. Public Service Commission, 262 U.S. 679, 692 (1923), and approved again in FPC v. Hope Natural Gas Co., 320 U.S. at 603, provides that "return" should be "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties." This "comparable earnings" standard, which has vitality for rate regulation,[44] was used by the Examiner in

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[42] In the Hugoton-Anadarko Area Rate Case, *supra*, 466 F.2d at 982-984, the Ninth Circuit took the position that it was not necessary for the Commission to make an express finding on rate of return, or that the court be able to estimate, on the basis of substantial evidence, in what range that rate fell. Circuit Judge Hamley believed that rate of return within the context of area rates, where actual rates of return would differ among producers, was inescapably imprecise and "not necessarily an indispensable or controlling factor." *Id.* at 983. We note, however, that all costs in the rate base are subject to the same imprecision.

[43] The effective average rate of return on flowing gas will depend (a) on how much of the price increment allowed by the Commission is not traceable to increased costs, and (b) the effective increase that will result from the escalation provisions.

[44] H. Leventhal, *Vitality of the Comparable Earnings Standard For Regulation of Utilities in a Growth Economy*, 74 Yale L. J. 989 (1965).

calculating a 10.5% rate of return for both flowing and new gas. The Commission increased this figure to 15% for new gas because of its desire to provide an extra incentive for new gas exploration. The same was obviously not required for flowing gas, which did not reflect an investment made "at the same time."

C. *Producer Challenges to Specific Cost Items*

Various producers challenge specific aspects of the FPC's cost calculations. We discuss the four most significant points they raise.[45]

Successful well costs

The producers' attack on calculation of the items of successful well costs is not insubstantial, but does not warrant an upset of this feature of the rate base. They object to the variable cost range of 2.70-4.10 cents per Mcf used by the FPC for new gas on the basis of what it considers underestimated drilling cost per foot figures. The FPC estimated that drilling costs could range from $22.22 to $24.66 per foot, depending on the method of trending data for increased costs. The producers argue that the $22.22 figure was derived from the 1967 Census figure of $24.39, which the FPC adjusted downward for unreported drilling costs of small producers.[46] The FPC made this adjustment on the basis of data reported to Census that these costs were 40% lower than those of the large producers, even though Census did not adjust its own figures because it considered the data based on an inadequate sample and of such poor quality as to be unreliable.

The issue does not warrant reversal. The Bureau of Census and the FPC have different functions. Census has

[45] Other specific challenges to features of the rate order are so insubstantial as not to require comment.

[46] 45 FPC at 693.

the obligation of reporting facts of our economy which may be put to a host of unknown and unknowable uses, and properly errs on the side of conservatism in reporting as fact only that which is knowable. The FPC, engaged in rate fixing, has room for judgment in its use of data beset by infirmities. The FPC proceeded on the premise that for every item of cost, there is a range of reliability in underlying data. The FPC established a variable cost range—to give a better idea of various possibilities it believed could justly be supported by the data. The objecting producers did not deny that small producers have lower drilling costs than large producers, even though the 40% extent of the differential was not reliably supported. Even the $24.39 figure proposed by producers is within the variable range used by the FPC. The FPC chose the high side of the variable range in calculating its new gas price. We see no substantial prejudice. As for the producers' claim that the high side of the range should be 30 dollars per foot, this is a conclusory statement supported only by a speculative estimate of how high drilling costs are likely to go in the future.

Exploration and development costs

The producers challenge exploration and development (E&D) costs, as calculated by the FPC for the flowing gas rate. They attack the method the FPC used in sorting out E&D costs assignable to gas exploration from those incurred on oil. This is an old and difficult problem.[47] The FPC adopted the Examiner's method, allocating costs in proportion to Btu's produced during a test year, with the Btu's of liquids increased by a multiplier of 3.4[48] to indicate comparative values.

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[47] *See* 45 FPC at 857.

[48] 45 FPC at 861 (Examiner), as adopted by the Commission generally, 45 FPC at 708-09.

The producers make two alternative contentions: (1) that the multiplier is arbitrary, or (2) a method of allocation utilizing direct assignments of exploration and development costs, as used in other proceedings, should have been adopted here.

As the FPC brief points out, the use of the "modified Btu method" in *Permian* and *Southern Louisiana I*, and the direct assignment method in *Southern Louisiana II*, led the FPC to conclude in those cases that the new methods changed the cost result by only one cent, and that this possible one cent error is more than accounted for "by the range of estimates implicit in the flowing-gas cost methodology." [49] *Compare* Other Southwest Area Rate Case, *supra*, slip op. at 26 suggesting, but not requiring, Commission reconsideration, where the FPC did not respond to the factual allegation that the direct assignment method would have made a 6.17¢ difference in the flowing-gas rate. Rate regulation is unavoidably approximate in nature. We cannot dictate a choice of formulas. The use of the "Btu adjustment method" was not arbitrary in light of its use in the past, the fact that its results approached those achieved with the newer direct assignments method, and in the context of the broad adjustments used by the FPC in its price determinations.

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[49] Brief of Respondent at 37 n.29. For the use of the "modified BTU method" in *Permiam* by the Commission, *see* 34 FPC 159, 217 (1965), and in *Southern Louisiana I*, see 40 FPC 530, 592-95 (1968), as aff'd in *Austral, supra*, 428 F.2d at 422. For the acceptance of the direct assignment method by the Commission, in *Southern Louisiana II*, in an opinion based on a settlement proposal, *see* 46 FPC 86, 136 (1971). We note that the argument on the basis of precedent has been "lifted" from the Commission's opinion in *Southern Louisiana II*, 46 FPC at 136-37, and does not appear in the Commission's decision in the instant case.

Royalties

The producers argue that in arriving at a royalty cost of 14% of the price set for gas, as applied to both the new and flowing gas rate, the FPC assumed, as it had held in Opinion No. 562 (42 FPC 164), that the royalty interest, just like the producers' working interest, is subject to FPC jurisdiction, and that Commission's prescribed "area rate" ceilings are equally controlling on the royalty owner. This jurisdictional assumption, as producers correctly point out, was upset in Mobil Oil Corporation v. FPC, 149 U.S.App. D.C. 310, 463 F.2d 256 (1971), *cert. denied,* 406 U.S. 976 (1972). The producers extrapolate from our *Mobil* decision by contending that we held that royalty owners could maintain collateral suits to recover payments based on alleged "current market values," and therefore royalty payments will exceed the FPC's assumptions of cost levels. But we observed in *Mobil,* without reaching the issue, that the fact that "market rate" royalty contracts would be left to the courts, did not portend a necessarily unavoidable conflict with area rates. Indeed, we noted:[50]

> Without purporting to rule on the matter in any way, we can certainly visualize the possibility that a court confronted with a contention of entitlement to a market price basis higher than the producer's ceiling would consider it to run counter to the intention of the parties, unless there is something to rebut the fair presumption that they contemplated interstate movement and market prices compatible therewith [footnote omitted].

Petitioners' claims are premature. The FPC could not meaningfully reflect an unknown and unknowable increment in royalty costs.

"50 BTU gap"

The final costing contention involves what producers have labelled as the "50 BTU gap." In Texaco Inc., 33 FPC 1228

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[50] 436 F.2d at 265.

(1964), followed in the *Permian* proceeding, the Commission established the general principle that a price adjustment is appropriate for varying Btu content of both new and flowing gas: an upward adjustment, for premium quality, from a level of 1050 Btu per cubic feet, and a downward adjustment, for shortfall in quality, from a level of 1000 Btu per cubic foot. Producers argue that these levels are not supported by the record, and that Btu adjustments both upward and downward should be made from the base of 1000 Btu per cubic foot.

The paradigm for the calculation of levels was developed in *Southern Louisiana I*.[51] In that proceeding the FPC adopted a base range rather than an exact base, as lessening the need for continual ceiling adjustments and agency monitoring; used the 1000 Btu base as a minimum notwithstanding average deliveries were at 1037 Btu, in order to avoid disturbing established industry practice; and balanced the savings thus accruing to producers by setting an upper level above 1037, put at 1050 as a matter of judgment. This justification for use of a range is reasonable. As to the location of the range, the producers show even less prejudice in the present case, in view of the Examiner's finding that the weighted average of deliveries was at 1047 Btu, even assuming, as the producers contend, that the trend is downward.

As for the use of 1000 Btu in Hugoton-Anadarko Rate Proceeding, 44 FPC 761 (September 8, 1970), that was a settlement, and did not adopt a principle that must thenceforth be maintained as a standard.

D. *Challenges to the Division Date and Moratorium Division Date*

New York Public Service Commission contends that the October 1, 1968, division date between flowing and new gas

[51] 40 FPC 608-10.

is unreasonable, and argues for a later date, giving consumers a lower price (the 19 cents flowing gas rate) on more contract years of gas. The contention is that the allowance for incentive factors to achieve increased supply included in the new gas price of 24 cents can serve no purpose to elicit discovery for gas already discovered and under contract.

We have difficulty with the FPC's rejection of this contention on the basis of "administrative convenience," that this same division date has consistently been adopted in other area rate proceedings. While it might permit a certain standardization in forms for keeping track of information, certainly any mechanical difficulty involved in keeping in mind different dates of the various rate vintages of gas for the several areas cannot seriously be urged as a legitimate reason for putting a 25% rate increase (between 19 and 24 cents) in effect for deliveries during a two and a half year period. While *Permian* referred to administrative convenience, that went merely to the *eight day* period between the start of the Permian Basin Area Rate Proceeding and the date fixed for the commencement of new gas rates.

We do, however, think that this case may be brought within the reasoning of *Permian* sustaining the non-correspondence between the division date and the prospective application of the rate order. The Court approved the Commission's action there establishing a price for new gas in 1965 applicable to gas committed to interstate commerce since January 1, 1961. Although stating (390 U.S. at 798-99) that "[i]t is difficult to see how the higher rate could reasonably have been expected to encourage, retrospectively, exploration and production that had already occurred," the Court noted the Commission's argument that its Statement of Policy issued on September 28, 1960 establishing a 16-cent guideline price for new gas sales in Permian, plus the commencement of the Permian area rate proceeding itself on December 23, 1960, had created expectations of higher

rates among producers which fairness required it to satisfy in fixing the starting date for its new gas-well gas rate. The Court concluded, 390 U.S. at 799, that these factors provided a "permissible basis" for the Commission's choice.

In 1968, the same year that *Permian* issued, the FPC stated in *Southern Louisiana I* that the

> use of the same division date as was used in the Permian Basin will ensure equality of treatment in this respect among producers operating in different pricing areas—a producer should not be penalized by having a later division date exclude its gas from the new gas category solely because he chanced to be in one area rather than another, unless strong and sufficient reasons are shown for the different treatment.[52]

While an argument based on the same treatment for producers in different areas has a certain surface appeal, we think it cannot be pushed too far. The very concept of area rate proceedings produces unequal treatment to some extent: even though nationwide cost figures are used, the Commission has not adopted nationwide prices. Given the time lag in area proceedings, the 1968 division date could recede farther and farther behind the date of an FPC order issued to encourage "new" gas.

However, given the 1968 ruling in *Permian* and the expectations generated by the FPC's 1968 statement in *Southern Louisiana I*, (even if not wholly sound), and taking into account the need for some cost increase above 1961 prices if a different division date is taken for new gas, we think an upholding of the FPC action as an application of Permian's fairness concept marks the course most appropriate for this court. This is not wholly logical, but the Supreme Court knew that in *Permian*. The Supreme Court noted that it was acting with reluctance; we likewise note our reluctance. If the point is extended too far, it can

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[52] 40 FPC at 555.

become a mockery; but if that point has been neared in the case before us, it has not been passed.

However, it is incumbent on the FPC to reexamine its policies, with a view to breaking this expectation-fulfillment cycle if it serves no legitimate end, if the requirement of reasoned decision-making is to be observed, and the function assigned to FPC of produce rate regulation is to be fulfilled in accordance with law.

Moratorium

The question remains whether FPC's imposition of a moratorium on price increase filings until January 1, 1976, was a permissible exercise of its authority. In *Permian* the Supreme Court accompanied approval of a similar moratorium with the caution, "we intimate no views on the propriety of moratoria created in circumstances of changing costs," 390 U.S. at 781, a circumstance now concedely the forecast for the Texas Gulf Coast Area.

Individual producers are not prevented by the moratorium from seeking relief from the maximum rates, as appears from the provisions for special exemptions and the availability of motions for modification or termination. Producers may be correct in arguing that the automatic and contingent escalation provisions on flowing gas do not provide enough flexibility in rates, and will not adequately cover anticipated cost increases. Yet the rate order's determination of the "just and reasonable price" will only come into conflict with the moratorium provision when, and if, increased costs are not adequately covered by the rates and no relief is granted by the Commission. We need not anticipate a change in circumstances before it occurs.

VI. CHALLENGES TO BASE RATES

In this part of the opinion I explain why I disagree with the decision of the majority, reflected in the opinion filed

by Chief Judge Bazelon. The reader will have to read Judge Bazelon's opinion before considering this Section VI of my opinion. If I understand it correctly, the majority has decided to remand the base area rate to the Commission on the ground that the FPC's increase in the base rate chargeable by producers in the Texas Gulf Coast area is not adequately justified, since the FPC's selection of a reference point in the zone of cost data was influenced by supply considerations without any determination of the amount of increased supply projected as ascribable to the resulting increase in base rate.

Much of what is said in Judge Bazelon's opinion is interesting, and should be of interest to the legislators who may come to consider whether the Natural Gas Act of 1938, as previously amended, should be further amended or perhaps repealed. The history of natural gas regulation is particularly valuable for those who have not lived through it, and I confess to a middle-aged and sentimental yearning for the simpler days of yore, and for the problems that were being discussed when I was engaged for a few years in teaching natural gas regulation at New Haven during the late 1950's.

1. My problem is to discern what Judge Bazelon's opinion has to say for the case before us. It might be relevant if there were a petition to review filed by New York on the ground that the base rate was too low and was inadequately justified. But as is plain from the record, and recognized in one of Judge Bazelon's footnotes, New York does not present any objection to the base rates, either for new gas or flowing gas. While New York's application for rehearing did present to the Commission its objection that the Commission had provided "an over-generous price for new gas" (point 9), and had provided only a few conclusory statements that were inadequate to discharge its responsibility "to discuss in detail the supply to be elicited at the rates

established" (point 10) it has not preserved any objection to the base rate in its petition for review. New York stated in its brief (p. 11):

> The Federal Power Commission in this case has established maximum prospective rate ceilings for new and flowing gas produced in the Texas Gulf Coast area at 24 cents per Mcf and 19 cents per Mcf respectively. These rates are each approximately 5.3 cents in excess of the rates proposed for new and old gas-well gas by its Presiding Examiner in his Initial Decision. However, while New York does not agree with much of the methodology utilized by the Commission in reaching these results, or with a number of the specific findings or absence of findings made by the Commission in support thereof, New York has, with the limited exceptions noted below, chosen not to challenge this portion of the Commission's determination. We have reached this conclusion in the light of the current gas supply situation, which has caused the New York Public Service Commission to impose moritoria on many types of new sales by New York distributors and has resulted in serious curtailment by the interstate pipelines of existing firm obligations of their New York customers, and our belief that levels approximating those here fixed by the Commission could be justified by a proper decision upon a more up to date record.

A federal court exists to decide only cases or controversies. When a case enters the federal court system by a prayer to a circuit court of appeals to reverse an order of a federal agency, it is the pleading containing this prayer that presents the controversy between the petitioner (or appellant) and the agency. That pleading of New York contains no objection to the base rate. New York does not ask this court to engage in an academic exercise, and I think settled rules of judicial functioning and administration indicate we should neither do so ourselves, nor require the Commission to do so.

2. Judge Bazelon says that an objection to the base rate has been preserved by the producers. Section 19(b) of the

Natural Gas Act provides: "No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure to do so." This provision is faithfully applied by the courts, *see, e.g.*, Permian Basin Area Rate Cases, *supra*, 390 U.S. at 825, n.116 (1968).

The objection found meritorious in Judge Bazelon's opinion is that the FPC erred in selecting a cost predicate for the base rate, albeit within the range of costs as elicited from the testimony (with suitable up-dating), because the "supply" reason of the FPC for its choice within that range were not adequately supported in its opinion. I now set forth the presentations made by the producers, which show, I think, as to the objection raised by Judge Bazelon. that "such objection" is not the one that was presented by the producers to the FPC.

There are numerous producer-intervenors before us: While their applications for rehearing differ somewhat one from another, the objections made by the producers adequately appear from the following sample, italics having been added for emphasis.

Humble's application for rehearing states:

> Although this Application for Rehearing sets out in detail matters which the Commission should, in our view, reconsider, we wish to express at the outset our basic agreement with the approach utilized by the Commission in Opinion 595. For the first time in area rate regulation, the Commission has recognized that the cost calculations on the record are *not* mathematically precise, but contain arbitrary judgments as to allocation procedures and a wide margin of error in both data and methods utilized (pp. 10-11). The Commission has also clearly recognized in Opinion 595 that area ceiling prices should serve a supply-eliciting function and that the gap between gas supply and demand has reached crisis proportions (pp. 11-14). The Commission prop-

erly found a wide range of current costs as constituting the "zone of reasonableness" for area ceiling prices, and selected a price which it believed to be supply-eliciting (p. 35). These are principles which the undersigned producers have long advocated, and we fully support the Commission's adoption of them. The concept of escalating prices for gas delivered under pre-1961, and 1961-1968, contracts for different time periods is sound and is supported by the increase in costs which has occurred over this time period as well as by the increasing need for internally generated capital for additional gas exploration. The cut-off dates selected by the Commission are also valid and appropriate, assuming different vintaging is required. The specifications of error which follow deal with what we believe to be improper applications of these principles. (R. 42,025)

. . .

The Commission correctly recognizes that there is no reliable manner in which it, or anyone else, can forecast the amount of new gas reserves that would be committed to the interstate market as a result of any specific change in rates (p. 14). In this respect the Commission gave recognition to recent evidence concerning the levels of prices in the intrastate markets in the Texas Gulf Coast Area. As a result of the Commission's investigation in Docket No. R-389, it was determined that in the first half of 1970 intrastate prices ranged up to 24.38 cents per Mcf. The Commission recognized that the trend of intrastate prices in the area is upward (p. 37).

The Commission's action in establishing new gas rates at 24 cents per Mcf is clearly erroneous in light of (1) the understatement of the range of new gas cost estimates from which such level was selected; (2) the minimal increase (after adjustment for inflation) which such rate represents over rates which have failed to elicit sufficient supplies; and (3) the inadequacy of such rate to enable the interstate market to obtain gas supplies in this area. (R. 42,028-29)

Continental Oil Co.'s application for rehearing concludes (JA 793-4):

> In view of the critical gas shortage, the need for drastic surgery on previous ineffectual and inadequate efforts is urgent. The Commission needs to re-evaluate its entire area price approach and reject completely the hypocritical pretence of costing. A new regulatory method more in line with the economic realities of the industry needs to be devised. Fundamental to such new method must be recognition of a single price system whereby all gas is priced on a value basis.
>
> The price level set by the Commission must be sufficient to give incentive for finding new gas. *While such incentive may be a matter of judgment, followed by trial and error, it must be at least 30-35¢ an Mcf in order to begin to complete* [sic] *with intrastate levels.* Evidence since the close of the record may indicate that such levels are even higher.
>
> WHEREFORE, for the foregoing reasons, the Commission should grant rehearing of Opinion No. 595 and upon rehearing modify its area pricing to provide a single price for all gas for all periods of time, regardless of date of contract. Such price should be higher than the "new gas" vintage level established in Opinion No. 595, for the reasons set forth in the Application for Rehearing of Indicated Respondents, and at least in the 30-35¢ range to provide any hope of incentive. (R. 42,142-43)

The joint brief filed by the indicated producer petitioners states (pp. 32-33):

> Despite the fact that the Commission recognized that the gas supply shortage was rapidly growing more serious and that this shortage was engendered at least in part by inadequate regulated field prices, it nonetheless "elected to go through the methodology used in earlier cases" (R. 41,884) and utilized the *Permian* methodology as a "point of departure" (R. 41,885). Having found that such costs are inaccurate within the range noted, the Commission should have discarded them as a point of departure. Failure to do so had the effect of depressing the ceiling rate levels below what

the supply evidence indicated, amounting to an abuse of the Commission's discretion.

Should the Court find that the use of such costs is discretionary, then we would further show that the Commission understated the range of costs, and that the limits of the range are actually much higher than noted in the opinion, as disclosed by evidence in the record. Finally, because of the rapidly worsening supply shortage the Commission should have prescribed ceiling rates reflecting the upper end of the range, rather than at the middle or lower end. Under the circumstances here, this was an abuse of the Commission's discretion requiring a remand.

The fact that producers filed an objection or objections to the base rates on the ground of inadequacy of FPC methodology does not mean that it is the same objection as that on which the court is ruling, so that the court can fairly say that "such objection" was presented to the FPC. Judge Bazelon says that the FPC did not adequately set forth a forecast of the new reserves that would be committed. But as the foregoing applications show, the producers' view is that the FPC correctly recognized that there is no reliable way of forecasting the reserves that can be committed as a result of the price change; and their objection, starting with that premise, is that since basically there must be an exercise of judgment, combined with trial and error, the interstate price must at least be equal to the intrastate price; that the cost range would permit a higher base price; that an incentive price should be nearer the high point of the true cost range; and that a contrary approach is in excess of the FPC's permissible discretion. All these objections are far different from the objection found justified in Judge Bazelon's opinion.

3. If the objection constructed by Judge Bazelon were properly before us, I would not agree with what Judge Bazelon has done. It seems to me that what the FPC has done, as a matter of methodology, is not beyond the range

of discretion that is properly the Commission's and is not unreasonable; that there are large areas of government regulation of industry that call for judgment and necessarily admit of considerable imprecision within the "zone of reasonableness"; and that Judge Bazelon's opinion would constrain the Commission to seek a refinement in methodology that it has fairly indicated is not ascertainable and available.

For clarity, I emphasize that I am not here speaking to a situation in which an agency increases a ceiling price for supply reasons without any reference point in costs. This the FPC did not do—and, as stated elsewhere in this opinion, there is firm support for its conclusion that the econometric principles propounded by producers had an appearance of scientific support that was belied by the sponginess of the assumptions and techniques on close examination.

If I may put the matter in my own words, raising prices to obtain supplies without any foundation in cost analysis comes close to bargaining with the sellers solely in terms of asking at what price they would be willing to sell. While that may be appropriate for an unregulated market, it has no serious place in a program of government regulation.

Similarly, the Act does not permit a charade of regulation that rests in truth on a premise of nonregulation (see *supra* pp. 25-26), e.g., by rubber-stamping the prices reached in an unregulated market.

As to the issue before us, on the other hand, there are pertinent cost estimates. Now if the evidence shows a reasonably firm cost prediction in a range of, say, 24 cents to 26 cents per Mcf, I see no objection in principle to a determination by a Government agency along these lines: The range is between 24 cents and 26 cents per Mcf. No exact answer is possible, and the determination requires

the exercise of judgment. We cannot know exactly how much more supply will be available at 26 cents than at 24 cents. Any investigation along those lines would reduce itself in the last analysis to an inquiry of sellers, and that is impracticable in view of their claim that a still higher price is what is really needed for supply—a claim that undercuts any meaningful answer as to willingness to sell at the lower price provided by even the highest point in the cost range. Under the circumstances, it is a responsible exercise of judgment to stay within the anchor of a cost range, but within that range to veer to the high side to avoid taking unnecessary risks of curtailing supply, at least at a time of shortage when the interest of consumers as well as the general public lies in avoiding unnecessary risk to supply.

It seems to me to lie within the discretion of the agency, and the domain of responsible regulation, to make a determination that reflects such an approach without undertaking a kind of meaningless and diversionary make-work effort at quantification.

4. Even the remand required by my opinion for the unanimous court opens the way to an agency's reformulation of base rates. The FPC might well say that it had set a base rate on the assumption of conditions the court has found improper, and that if it is not to have the premise of such conditions, it finds another base rate appropriate. But that would have been a matter of administrative latitude in the exercise of the agency's on-going function following a judicial remand. What causes me to differ from Judge Bazelon's opinion is my concern lest it operate to require a remand proceeding that is unrealistically and unnecessarily refined, in pursuit of a regulatory will of the wisp.

I fear that Judge Bazelon is turning from Socrates, and his concern with the limits of knowledge,[53] to Plato, and

[53] See opinion of Chief Judge Bazelon in No. 72-1517, Inter-

his quest for the ideal. Judges, however, must deal with the workaday world. In judicial review of administrative regulation courts have a dual role, of supervision of administrative agencies, and of responsible partnership in the public interest. They cannot fairly demand the perfect at the expense of the achievable.

VII. CHALLENGES TO INCENTIVE PROVISIONS

The FPC established non-cost based incentives to reduce the critical supply shortage. First, a contingent escalation in flowing gas prices for producers as a group, when certain specified new dedications of natural gas were made to the interstate market. Second, a credit of one cent per Mcf, toward discharge of refund obligations, for each additional Mcf of new dedications—subject to a provision to avoid double counting of dedications.[54] A number of challenges to both of these provisions are reviewed below.

A. *Contingent Escalations*

The provisions for contingent escalation are attacked as (1) adopted on inadequate hearing procedures; (2) lacking findings that these incentives will materially improve the supply situation; and (3) having a discriminatory and anti-competitive effect.

Hearing procedures

Area rate proceedings conducted under Sections 4 and 5 require a hearing and decision "supported by substantial evidence," under § 19(b) of the Natural Gas Act. Petitioner Mobil Oil Corporation contends that both incentive provi-

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national Harvester Co., et al. v. Ruckelshaus, February 10, 1973 (slip op. at 63).

[54] Reserves dedicated for refund reduction are not to be counted toward new dedications needed to trigger the contingent escalation on flowing gas.

sions were not subject to development through a hearing, and thus are not based on record evidence.

The Examiner's voluminous findings were based on hearings which began after the institution of the proceeding on November 27, 1963 and extended until his initial decision issued September 16, 1968. Some 25,000 pages of Joint Record were developed in hearings held jointly with the Hugoton-Anadarko Area Rate Proceeding, with another 5000 pages added in separate hearings pertaining only to the Texas Gulf Coast Area.[55] The working assumption throughout was that prices were to be cost-based, and that adjustments for an increased level of supply would be accomplished through the uniform pricing system. Thus, there was no presentation on incentive provisions, or such issues as (1) the size of such escalations needed to produce a given supply, (2) the relationship between such provisions and the incentives contained within the uniform price system, or (3) the actual returns different producers with different quantities of "flowing gas" might realize from these contingent provisions.

The incentive provisions were adopted *ab initio* by the FPC in its Opinion No. 595, (issued May 6, 1971) and were justified principally on the basis of record evidence indicating the shortage of supply. The FPC stated:[56]

> The present critical shortage of all forms of energy in the United States and the anticipated rapid growth of demand for natural gas in particular makes it imperative to provide incentives to find gas and dedicate that gas to the interstate market . . . . Accordingly, we believe it necessary and desirable in the public interest that incentives be offered independent producers of natural gas above and beyond the price we have fixed in this proceeding.

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[55] 45 FPC at 680.

[56] 45 FPC at 709.

In Opinion No. 595-A, and "Order Modifying and Clarifying Prior Order [595] and Denying Rehearing," the Commission's only response to this challenge was that "[t]he rate and rate design issues raised in this hearing" were similar to those raised on rehearing in another area rate proceeding, *Southern Louisiana II*, and that it was "unnecessary to repeat what we said in that opinion." [57] In briefs and oral argument, Commission counsel lean heavily on the *Southern Louisiana II* opinion to support the incentive provisions adopted here.

Need for substantial support in the record

Even assuming the FPC's shift from adjudicatory to rulemaking procedures survives judicial scrutiny here and in other proceedings [58] as a permissible interpretation of the Natural Gas Act and Administrative Procedure Act,[59]

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[57] 46 FPC at 830.

[58] Rocky Mountain, Order No. 435, 46 FPC 68 (1971), adopted a rule-making proceeding, and this was approved in Phillips Petroleum Co. v. FPC (Slip Opinion, February 20, 1973, 10th Cir.). The Appalachian-Illinois Order No. 411, 44 FPC 1112 (1970), to similar effect, was not appealed. A case currently before this court, American Public Gas Association v. FPC, No. 71-1812, raises similar questions.

[59] As noted in the text, we believe that the "substantial evidence" standard requires a decision on the record but not necessarily with adjudicatory procedures. However, under the Administrative Procedure Act, 5 U.S.C. §§ 553, 556 and 706, a "substantial evidence" standard of judicial review is usually the handmaiden of § 556 procedures, whereas rule-making proceedings are reviewed under the more narrow "arbitrary and capricious" standard. This may not always be the case, since § 556(d) contemplates the limiting of adjudicatory procedures even when § 556 clearly applies. It is this type of hybrid which would be created by permitting rule-making under the Natural Gas Act.

nevertheless the Natural Gas Act, with the provisions in § 19 that Commission decisions be reviewed under a "substantial evidence" standard, contemplates that the agency decision be made "on the record."

In *United States* v. *Florida East Coast Railway Co.*,[60] Justice Rehnquist, speaking for the majority, decided that adjudicatory procedures afforded by the Administrative Procedure Act, 5 U.S.C. § 556, would not automatically be available, unless the basic statute—there section 1(14)(a) of the Interstate Commerce Act—expressly specified that the rule in question was to be made "on the record after opportunity for an agency hearing." Even if the rationale of *Florida East Coast* is applicable to producer rates issued under the Natural Gas Act, a question we need not reach, that case was concerned only with determining when the Commission must employ adjudicatory procedures. A separate question is presented as to when a decision must be made "on the record," whatever the procedures used to compile it. We take the statutory requirement of "substantial evidence" in § 19 of the Natural Gas Act to reflect a congressional intent to limit agency determinations to record evidence.[61] In *Phillips Petroleum Co.* v. *FPC*, where the Tenth Circuit held that the Commission could conduct area rate hearings under rule-making procedures, the court indicated its agreement with this view, stating:[62]

> The final contention of the petitioners is that there can be a valid judicial review only if there is a record. However, we do not agree that this requires that there be a record resulting from a formal evidentiary hearing. . . . The submissions of the petitioners would be

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[60] 410 U.S. 224 (1973).

[61] *See* Universal Camera Corp. v. Labor Board, 340 U.S. 474 (1951).

[62] Slip Opinion at 22-23.

placed in public files and made available for public inspection. Thus the petitioners are aware of the material which will be considered together with the application of Commission expertise to the information submitted.

Finally, the reviewing court is at liberty to remand the cause to the agency for further delineation, information or expression of views.

Reference to Southern Louisiana II proceeding

In the instant case, FPC counsel assert that critical features of the rate order—contingent escalations and refund discharges—can be adopted in this proceeding, on the basis of the record and decision in *Southern Louisiana II*.

The use of *Southern Louisiana II* as a constructive record underlying the *Texas Gulf Coast Area* order runs into problems of sequence and timing. *Southern Louisiana II* was issued on July 16, 1971, more than one month after the FPC's opinion in the instant proceeding, issued on May 6, 1971. Indeed, the *Southern Louisiana II* opinion relied, on issues other than the incentive provisions, on the *Texas Gulf Coast Area* opinion.[63] While the *Texas Gulf Coast* opinion 595-A, denying rehearing, did issue subsequent to *Southern Louisiana II*, so late a cross-reference to justify a central requirement of the rate order raises problems. Doubtless, both orders reflected a view that the Commission had been in the process of forming, yet its order presented to us must have substantial basis in the record presented to us. Without pressing this matter of sequence further, we observe that the technical footing for the avoidance of a record or reasons by reference to *Southern Louisiana II* is somewhat slippery.

Secondly, a problem surely exists with using the *record*

[63] 46 FPC 128-132.

from *Southern Louisiana II*. The FPC was not setting national rates,[64] but was holding separate hearings in rate proceedings for different areas. We see no basis for charging the parties in one proceeding with notice of the contents of the record in another proceeding unless a fair procedure is adopted to alert the parties of a proposed incorporation by reference, and to give the parties in the second proceeding a clear opportunity to respond, by challenging the evidence transferred, or pointing out distinctions that limit the utility or propriety of transfer.[65] *See* M. Dakin, *Ratemaking as Rulemaking—The New Approach at the FPC; Ad Hoc Rulemaking in the Ratemaking Process,* 1973 DUKE L. J. 41, 76 n.173.

Third, we focus on the fact that the opinion in *Southern Louisiana II* was based on a settlement proposal. The fact that *Southern Louisiana II* was a settlement was relied upon by the Commission, in significant measure, to sustain its order in that proceeding. 46 FPC at 103. Yet in a settlement, trade-offs on a wide range of pricing issues may have induced various participants in that proceeding to forego a legal challenge to the incentive provisions. "The parties may be disposed to avoid the expense and distrac-

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[64] This is not to say that the Commission does not have the authority to promulgate national rates, but that approach is certainly inconsistent with the approach taken by the Commission in this proceeding.

[65] "[In] any situation in which the Commission wishes to incorporate evidence from another proceeding, it must give the interested parties notice and an opportunity to comment on such evidence. * * * The Commission would not be free to incorporate as evidence mere conclusions reached by the Commission in other proceedings. By like token, the Commission would not be free to adopt factual assertions (such as settlement offers) which had not been subject to examination and testing by opposing parties." Mobil Oil Corporation v. FPC, #72-1471, —— U.S.App.D.C. ——, —— F.2d —— (slip opin. at p. 49, note 93).

tions of litigation if . . . a settlement [does] not constitute a binding admission or ruling on principle." City of Chicago v. FPC, 128 U.S.App.D.C. 107, 119, 385 F.2d 629, 641 (1967).

Finally, the cross-reference to *Southern Louisiana II* was almost casual, and indeed the FPC did not explicitly say that this reference related to the challenge on the incentive provisions.[66] That position has been refined in briefs and oral argument of counsel, but these are not an adequate substitute for consideration and articulation by the agency.[67]

We conclude, therefore, that the Commission cannot properly rely on the record of *Southern Louisiana II*, due to the lack of opportunity given to petitioners to respond to the incorporation of that record. We now move to a discussion of the evidence in the proceeding before us justifying the incentive provisions.

Relationship between incentives and required increase in supply

The FPC's reference to the energy shortage as the reason for the incentive provisions properly calls on us to

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[66] The Commission merely stated, 46 FPC at 830:

> The rate and rate design issues raised in this proceeding are in many respects analogous to those raised on rehearing in *Southern Louisiana II* . . . . We find it unnecessary to repeat what we said in that opinion, which is generally controlling and dispositive of similar issues raised here. We thus incorporate by reference in this opinion our decision in Opinion No. 598-A, issued September 9, 1971.

[67] Burlington Truck Lines v. United States, 371 U.S. 156, 168-69 (1962); Braniff Airways, Inc. v. CAB, 126 U.S.App. D.C. 399, 411, 379 F.2d 453, 465 (1967); International Harvester et al. v. Ruckelshaus, Slip Opinion No. 72-1517 (D.C.Cir., February 10, 1973).

consider the record evidence that is available in this proceeding on the supply shortage, and other evidence in regard to adjustment of the price of flowing gas for eliciting increased supply. The existence of some record and some reasons, gives the FPC order the presumptive validity outlined in *Permian,* unless this is undercut by petitioners.

Certain petitioners contend, broadly, that the FPC has presented no rational connection between the amount of incentives provided and the expected increase in supply of natural gas, that, in effect, the supply shortage *per se* cannot be used to justify any and all possible measures the Commission may take to reduce that shortage in any degree, to give a blank check to producers with no assurance that consumers will thereby benefit.

The Commission and producers defending the incentive provisions argue that (1) the degree of arbitrariness in the incentive provisions, in terms of eliciting supply, is no greater or different than that which attaches to flowing gas prices, which have been calculated, in part, to produce increased supply; (2) the incentives will generate capital funds, and an extremely high percentage of outlays for discovery of new gas comes from this source of capital; and, (3) the incentives are only given on an "if . . . come" basis, so the price to the consumer will only be increased if the desired amount of gas is forthcoming.

These contentions of the defenders of the rate order are substantial refinements from the findings and conclusions of the Commission below. They represent an improvement in analysis, over the FPC's bare position that the supply shortage *per se* justifies the incentive provisions, as approaching a "hard look" at the reasonableness of the incentives.[68] However, these were not the justifications ad-

[68] Morgan v. United States, 304 U.S. 1 (1938); Greater Boston TV v. FCC, 143 U.S.App.D.C. 383, 392, 444 F.2d 841, 850, *cert. denied,* 403 U.S. 923 (1971).

vanced for the measures adopted by the Commission, either in its initial opinion where these were interjected into the proceeding, or in response to the petition for rehearing, where it had the benefit of petitioners' specific challenge. We remand to the Commission for its statement of its reasons, in view of the void that now exists. We are strengthened in this course by difficulties we see with these justifications, which the FPC should be given an opportunity to take into account, in reexamining the relationship between non-cost incentives and the expected increase in supply.

The Fifth Circuit in Placid Oil Co., supra note 2, at p. 21 (slip opin.) stated "What the nation needs is gas, that is, gas that is burnable". We agree. We cannot accept, however, a result under the Natural Gas Act in which the mere need for supply automatically justifies any and all proposals, or demands, by the person able to provide the needed supply. We believe it is important that alternative means be considered from the viewpoint of protecting the consumer, taking supply considerations into account, but not exclusively, and that the means finally chosen be evaluated against possible alternatives.

Flowing Gas Price Analogy

The Commission and the producers analogize the incentives to the supply adjustments made in the price of flowing gas. The majority of the court has concluded that these upward adjustments are themselves inadequately justified by the Commission as a response to the supply problem. But even if the upward adjustments had been approved, the analogy that the Commission and the producers seek to draw between them and the incentives is incomplete in one critical respect. The upward adjustments are at least within a range of cost-based levels. The methodology used by the Commission in arriving at the new gas price also has a cost-based orientation. When the Commission employs pure non-cost incentives there is no cost

anchor that even arguably serves as a benchmark for the reasonableness of the rates.[69] Thus, the use of pure non-cost incentives poses an issue different from those involved in adjustments or choices of base rates. It is hard enough to determine the amount of benefits to producers, and burdens to consumers, over and above familiar cost of service (including fair return), that may reasonably be projected to elicit a needed increment in supply. These difficulties are inherent in incentive programs. It is hard to discern what reason could justify an agency acting in such a way as to provide incentives without a glimmer of their extent. As to incentive provisions on newly discovered gas, the relationship of benefits to burdens have at least a measure of reasonable ascertainment in terms of the volumes of new discoveries, which can be measured against the escalation provided in the rates for those discoveries. The same calculation is not meaningful for flowing gas, because of the inherent differences between producers in the amount of flowing gas under contract. This not only raises a problem of discrimination discussed subsequently, but also makes it difficult to assess the rate burdens to consumers from an increase in these prices.[70]

If, as must be assumed, prices have been set for new gas that fully reflect the costs of exploration, including failures and the cost of attracting money (rate of return) to the exploration enterprises, then it is difficult to discern the argument for an extra allowance on *existing* gas flows, in

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[69] *See* cases cited note 31 *supra.*

[70] In its brief, at 14, n.7, the New York Public Service Commission estimates that there are 15 trillion cubic feet which will be entitled to the two cent bonus if and when the producers find the necessary new gas. This, they go on to estimate, will equal $300,000,000 payable for finding the new gas, or an extra three cents per Mcf. The Brief For Indicated Producer Intervenors, at 7 n.3, states that this calculation is based on pure speculation.

the interest of providing an incentive to explore for *new* gas. The Commission's brief insists that the FPC must have latitude to develop incentive provisions to meet exigencies (p. 42). We agree with this generality, and agree that it is supported by our decision in Public Service Commission v. FPC (Natural Gas Pipeline Co.), —— U.S. App.D.C.——,——F.2d (March 29, 1972). But it is subject to a necessary premise that there be some justification, that the provision put forward as an incentive to exploration have some rational relation to the objective of exploration. That decision involved the FPC's handling of advance payments made by pipelines to producers "for exploration and lease acquisition costs." In upholding this as a means to ensure that necessary capital for development will be forthcoming, the court pointed out that this advance was not unreasonable on its face "since ultimately the consumers must be ready to shoulder the costs of such operations, if they are necessary to supply them with power." But in the case at bar the consumers who are being asked to shoulder the costs are not the same as the class of consumers who will be receiving the supplies. That is the nub of the problem.

The intervenor-producers' brief argues (p. 8): "A primary basis for the Commission's provision for contingent escalation of flowing gas prices was the recognized need to increase the availability of capital funds to gas producers in order to finance the expanded search for new gas reserves." What the Commission in fact said (R. 41,924) was that as a result of its orders, sources of adequate financing will be available for exploration and development in the Texas Gulf Coast, with a large portion of the funds internally generated by the increased cash flow from gas flowing under pre-1968 contracts. The FPC did not say that this flowing gas increase was necessary to obtain exploration funds, and indeed it had already increased the prices for new gas in order to assure exploration capital. It is ele-

mentary in the petroleum industry that capital is provided for exploration in an area long before there are any funds flowing from that area—demonstrated, e.g. by the funds invested in Alaska, and in purchase of Gulf Coast off-shore leases offered by the Interior Department.[71] It is obvious that future expenditures in any particular producer area depend on evaluations of future profits, not past or recent receipts from activities begun in the past, at least where, as here, the future operations will be governed by price conditions far more liberal than prevailed at the time current operations were planned and developed. The fact that petroleum company retained earnings were equal to 85% of investment outlays during 1954-1963 [72] does not govern the present inquiry. It reflects both earnings retained out of gas and oil, and investment used for both gas and oil.[73] Investment in an area was not related to earnings from that area, but rather to a company-wide assessment of funds available and investment opportunities. It reflects the easier availability, and less expense, of use of retained funds, and the approval given that course by stockholders, but does not negate the availability of debt or equity financing.[74] In short, the producers' contention simply does not focus on the core questions involved in any program of enlarging receipts on flowing gas because of the pros-

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[71] NY Public Service Commission Brief at 22.

[72] Chase Manhattan Bank: Annual Financial Analysis Petroleum Industry Reports, 1954-1963, and Annual Financial Analysis of 32 Petroleum Companies (33 in years prior to 1963).

[73] The Examiner, 45 FPC at 824-35 assumed that the "comparable earnings' rate of return looked to statistical data of companies, as would seem appropriate for the equity investor in assessing the risk of investing in stock.

[74] *See* E. Solomon, Theory of Financial Management 51-53 (1963).

pect—there is no requirement—that these particular receipts be used for exploration for new gas. Before any such approach could be indulged, there would have to be a more reasoned statement from the Commission of necessity and propriety. Furthermore, the relevant risk to investors in the equity of integrated petroleum companies, would seem to be defined not by the risk of exploration activity but by the risk from the entire operations of the corporation.

While at the margin the cost of raising capital makes retained earnings from current operations a preferred source [75] for funds for new exploration, this does not establish that absent such earnings, all investment will be foregone.[76] What determines the decision to make an investment is the estimate of earnings from the new investment, and if that is projected as a return that justifies the risk, capital will be available. Similarly, if the projected returns do not justify the risk, capital will not be invested even though retained earnings are available from current operations. Firms must assess the opportunity cost of investing their retained earnings in new exploration, as opposed to other uses in active, or even passive, investment opportunities.

The plan does provide that increases in price only come after new dedications are made. The critical question, however, is whether companies will use the money generated from the increased price of flowing gas in new exploration activity. They will get their moneys faster from a rate hike on flowing gas than new gas, but what will they do with the money?

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[75] *See* Joint Appendix, Part II, Vol. 3, at 18, R. 1,832.

[76] Whether retained earnings may be a cheaper source of financing, raises a different question than whether they are the exclusive source. *See* Solomon, *supra* note 73, at 27 where he states that an investment will be made if "the rate of return it promises (correctly computed from expected outlays and benefits) exceeds the cost of capital."

In view of the absence of Commission analysis, we observe that our comments do not constitute an implacable prohibition on the use of flowing gas to raise required revenues. We have, however, identified substantial problems that the FPC will have to consider on remand.

Discriminatory and anti-competitive effects

Petitioners assert that the contingent escalation incentive is unduly discriminatory in its effects upon the industry, producing widely discrepant benefits for different producers, giving benefits to individual producers based not on their exploration, or even dedication to the interstate market, but on their previous volume of interstate sales (assuming an industry-wide dedication), and operating to the particular disadvantage of new entrants into the industry. Proponents of this feature of the rate order generally contend that discrimination between producers is inherent in the concept of area-ratemaking and that new entrants are not prejudiced by the flowing gas approach.

The issue of discrimination received a most cursory treatment by the Commission in its Order Denying Application for Rehearing. The Commission stated:[77]

> Texaco and Mobil object to the industry-wide incentives of price escalation for total industry dedications of new gas reserves. They would provide incentives, instead, for individual producers to make dedications. Mobil also suggests that simply giving higher prices without requiring new dedications would be a better incentive. While there is much to be said for individual incentives, and in a proper case they may be ordered, upon this record we are not convinced they are preferable in this area. This Commission is concerned with the incentives necessary for the producers to dedicate 10 trillion cubic feet in new gas reserves to interstate commerce. Accordingly, we found it in

[77] 46 FPC at 833.

> the public interest to provide industry incentives, rather than individual incentives. . . .

This is not an explanation but a conclusion, stating that the Commission would follow its announced policy. No semblance of analysis is indicated, in terms of the consequences upon industry structure from the provisions, nor is any reasoned consideration given to the alternative of an increase in the new gas price.

Section 5(a) of the Act contemplates that area rates should not be "unjust, unreasonable, unduly discriminatory, or preferential. . . ." [78] It is to avoid such results, that the Commission is charged with arriving at "just and reasonable rates." In view of this expressed purpose of the Act, there is need for the Commission to be sensitive and responsive to the discriminatory effects of area rate orders.

In *Permian,* Justice Harlan stated: [79]

> Judicial review of the Commission's orders will therefore function accurately and efficaciously only if the Commission indicates *fully* and *carefully* the methods by which, and the purposes for which, it has chosen to act, as well as its assessment of the *consequences of its orders for the character and future development of the industry.* (emphasis added).

The absence of an "assessment" was called into particular question by the Fifth Circuit in *Austral, supra,* at 441. Although the court was not willing to reverse or remand the order on that ground, the court indicated that "The Commission has considered few of these matters in this case, either prayerfully or otherwise, and this deficiency is of great concern to a reviewing court." 428 F.2d at 442. While *Austral* was concerned with a different, and perhaps converse, omission by the Commission—the failure to consider the supply shortage—the principal reason advanced

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[78] *See* note 2 *supra.*

[79] 390 U.S. at 792.

by the Fifth Circuit for not reversing and remanding was that the new proceedings, which ultimately led to the Commission's decision in *Southern Louisiana II,* were already underway for the major purpose of reexamining its prior order in light of changed supply conditions.[80] The Fifth Circuit also believed that *Permian* gave the Commission a grace period during which a less full and careful examination by the Commission would be demanded by the courts, due to the experimental nature of area rate proceedings.[81] In our view, allowance for experiment is, indeed, appropriate when applied to such matters as the level of price, and the difficulties of relating an incentive in the new gas price to a needed quantity of supply. The pragmatic need for room and time to experiment cannot substitute for reasoned analysis when the rate structure raises a serious problem of discrimination, a result which the statute expressly guards against, and which the Commission has long had experience in enforcing. Moreover, it is now five years after *Permian* and three years after *Austral.* As Justice Harlan cautioned in *Permian*:[82]

> We are, in addition, obliged at this juncture to give weight to the unusual difficulties of this first area proceeding; we must, however, emphasize that this weight must significantly lessen as the Commission's experience with area regulation increases.

Discrimination against producers with less or no flowing gas

We turn to the serious problem raised concerning discrimination against new entrants into the natural gas in-

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[80] 428 F.2d at 439.

[81] 428 F.2d at 440.

[82] 390 U.S. at 792. We note that in the Hugoton-Anadarko Area Rate Case, 466 F.2d 974 (9th Cir. 1972), there were no contingent escalations or "refund work-off" incentives.

dustry, a problem area made more complicated by the issue of anti-competitive effects. The discrimination against new entrants is plain enough. New entrants will, by definition, have no outstanding flowing gas. On new dedications to the interstate market, new producers will obtain only the authorized price for new gas; old producers, will obtain additional revenues through the authorization for increase in gas flowing under contracts and dedications of the past. This imbalance may impinge on competition—*e.g.*, in the bidding for new gas leases, old producers will be able to outbid new entrants due to the expected differential in total returns. Such a result would be inconsistent with the Commission's policy toward pipeline companies, whose entry or re-entry into the gas production arena is sought by FPC in the public interest.[83] Presumably this policy evolved, in part, as a response to the "market imperfections" noted in the past by the Supreme Court.[84] This traditional concern with competition in the industry makes it appropriate that the Commission assume the authority and the responsibility to consider this type of challenge and indicate its views.[85]

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[83] *See* Pipeline Production Area Rate Case, 42 FPC 738 (1969), *aff'd sub. nom.* City of Chicago v. FPC, *supra* note 31.

[84] *Permian, supra*, 390 U.S. at 793-95; FPC v. Hope Natural Gas Co., 320 U.S. 591, 628 (1944) (Jackson, J. concurring).

[85] City of Lafayette, Louisiana v. FPC, 147 U.S.App.D.C. 98, 105, 454 F.2d 941, 948 (1971), *affirmed sub. nom.* Gulf States Utilities Co. v. FPC, —— U.S. ——, No. 71-1178 (May 14, 1973). The Supreme Court assumed, and even the Commission admitted, in requiring consideration of anti-competitive practices of a utility issuing securities under § 204 of the Federal Power Act, 16 U.S.C. § 824c, that "allegations of competitive conduct properly may be raised and fully considered in other proceedings related to . . . rates and rate-making practices under §§ 205 and 206, 16 U.S.C. §§ 824d and 824e. . . ." Slip op. at 9-10. This applied even though, in the same term,

The question of discrimination and anti-competitive effects is not limited solely to a comparison between old producers and new entrants. Since old producers may differ significantly among themselves, in terms of flowing gas under contract, the incentive provision may also affect the industry structure as to producers already in the market. The shape and extent of this problem should be identified on the record and considered by the Commission on remand.

FPC counsel argue that area ratemaking is inherently discriminatory. (We are not clear whether FPC would take the position that it is inherently anti-competitive.) If some discriminatory effects are inevitable, they should be kept to the irreducible minimum. While price increases for flowing gas inherently advantage old producers and not new entrants, to the extent that they are intended to reflect the recovery of real costs, the effect on competition is collateral and diluted. Even when some supply adjustments have been made to this price, as here, cost still functions as an anchor and anti-competitive effects are minimized.

When we speak of the vice of discrimination, we do not have in mind the theoretical argument that even uniform prices provide different rates of return, depending on the cost structures and efficiency of the various producers. Generally, at least, uniform prices give all producers an equal opportunity to reduce their costs, or improve their efficiency, to maximize their returns. When a rate differential is fixed by federal regulation, without basis in costs, there is a handicap to opportunity that cannot be removed by effort of the disadvantaged producer to enhance efficiency and competitiveness. This is not merely a problem

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the Court decided that gas companies are not shielded from all antitrust liability because of FPC regulation. Otter Tail Power Co. v. United States, —— U.S. ——, Slip Opinion No. 71-991 (Feb. 22, 1973).

where "one producer's piece of cake is iced and another's is not." Placid Oil Co., supra, at 49. At stake is the consumer's interest in effective competitive conditions in the industry.

Discrimination against customers of flowing-gas producers

New York argues that there is invidious discrimination in that the bonus to producers from new dedications will be chargeable to their customers and consumers as a function of its past flowing gas take, regardless of whether the pipeline or other customers secure any or all of the new gas.

A regulatory system does not distribute costs and benefits in exactly equal proportions to consumers. The vintage rate system, for example, makes classifications of gas to which different costs attach, for different years of discovery and delivery. Vintage pricing of gas is based on average costs, and although costs may increase over time during a period, all consumers will pay the same price for the period. Yet *Permian* clearly sustains vintage pricing, if only for the administrative convenience of the Federal Power Commission. Similarly, administrative convenience has long recognized the propriety of zones of delivery for pipelines, with the same prices for all customers within a zone, although transmission costs are actually higher to those located farthest from gathering points.

There is a basic difference between reasonable classes or zones, with uniformity within the class or zone, established for administrative convenience, and a situation in which there is no inherent relationship between the consumers assigned the burdens and those deriving the benefits of a government pricing provision.

Such discriminatory effects would be minimized if the costs of new discovery were compensated by a higher price for new gas. Again, we stress that we are not precluding

the use of increased flowing gas costs; we are simply indicating to the Commission that certain disadvantages seem to inhere in such a system, and although they may have to be borne ultimately, they must be evaluated and weighed against other possible regulatory approaches.

B. *Refund "Work-off"*

Many of our comments above on the matter of contingent escalations, are also appropriate in regard to the refund "work-off" provision of the rate order, which provides that a credit of one cent per Mcf toward discharge of refund obligations is provided for each additional Mcf of new dedications to the interstate market, with the proviso that reserves dedicated for refund reduction are not to be counted toward new dedications needed to trigger the contingent escalation on flowing gas. The provision for the refund provision is subject to the same absence of explanation as the other incentive provisions of the rate order, and our observations on that point need not be repeated here.

This provision is also challenged as discriminatory and anti-competitive.

The work-off provision gives an advantage to sellers charging high prices in the past, particularly as a result of section 4(e) filings [86] which resulted in rates higher than those specified in the permanent certificate, for it lets them work off their refund obligation by dedications, giving them a preference over producers who had a lower potential refund liability or who had made cash refunds discharging their liability. This is a happenstance and capricious preference which is not accompanied by any justification of reasonableness.

Mobil argues that the preference is particularly un-

[86] 15 U.S.C. § 717c.

justified because, due to its relationship with contingent escalations, those producers who are working off refunds by new dedications can rely on other producers who make dedications (without receiving refund credits), to trigger contingent escalations for the industry, and thus derive a regulatory benefit without a corresponding contribution.[87] To some extent discrimination is inherent in the contingent escalation because it works on an industry basis, rather than on an individual producer basis. But it rubs salt in the wounds for producer A, who makes a full dedication, to know that not only is the same benefit accorded to producer B who makes no dedication whatever, but that an even greater benefit is accorded to producer C, who makes the same dedication as A, merely because his past conduct calls upon him to make equitable restitution.

Again, the refund incentive discriminates against new entrants who, of course, have no refund liability.

In addition to the above inter-producer effects, the Order discriminates, says New York, against the consumers who were owed the past refunds. FPC has provided that 50% of the new gas used to discharge refunds must be offered to those to whom the refunds were due,[88] but New York contends that all such gas should go to those owed the refunds. As in the case of contingent escalation, the imperfect match will result in a redistribution of the costs of new gas, as compared with a system in which refund liability was separately discharged and incentives limited to the price of new gas.

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[87] This benefit is analogous to the "free-rider" problem in economic analysis where one not participating in the cost of a good, nonetheless derives a benefit. Indeed, the avoidance of "free riders" is a primary impetus for the patent system. *See* H. Demsetz, Toward A Theory of Property Rights, 57 Am. Econ. Rev. 347 (1967).

[88] 45 FPC at 723.

There may be a sound explanation for the system adopted, but we have not been offered one by the Commission. The justifications, raised for the first time before this court, that the refund work-off will reduce the supply shortage, and that discriminatory effects are inherent in area rate regulation, are subject to our comments made in the context of contingent escalations. The Commission further asserts that the work-off must be sustained because of its special administrative discretion and power over the payment of refunds. We cannot agree.

Courts have traditionally held that there is broad discretion in the Commission to order the payment of refunds. As Justice Harlan pointed out in *Permian*,[89] a rate found to be unjust and unreasonable is declared by § 4(a) to be unlawful, and if the rate has been the subject of a rate schedule modification, the Commission is empowered by § 4(e) to order a refund. This is pursuant to the Commission's duty under the Natural Gas Act to protect the interests of consumers.[90] It is in accord with this statutory duty that the power of the Commission to order refunds has been upheld in a variety of circumstances.[91] As we stated in *Niagara, supra*, 126 U.S.App.D.C. at 382, 379 F.2d at 159, "the breadth of agency discretion is, if anything, at its zenith when the action assailed relates . . . to the fashioning of policies, remedies and sanctions, including enforcement and voluntary compliance programs in

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[89] 390 U.S. at 827.

[90] Atlantic Rfg. Co. v. Public Serv. Comm'n (CATCO), 360 U.S. 378, 388 (1959).

[91] *See* Mesa Petroleum Co. v. FPC, 441 F.2d 182, 186-192 (5th Cir. 1971); Continental Oil Co. v. FPC, 378 F.2d 510 (5th Cir. 1967); Niagara Mohawk Power Corp. v. FPC, 126 U.S. App.D.C. 376, 379 F.2d 153 (1967); Public Serv. Comm'n of State of N.Y. v. FPC, 117 U.S.App.D.C. 287, 329 F.2d 242 (1964), *cert. denied sub. nom.* Prado Oil and Gas Co. v. FPC, 377 U.S. 963 (1964).

order to arrive at maximum effectuation of Congressional objectives."

In this case, however, the Commission seeks to relieve producers from refund obligations, and to the extent that it does so it lets stand, without redress, past violations, and it promotes unjust discrimination and anti-competitive effects. Its first impetus lies, if anything, in thwarting rather than effectuating the policies behind the Act, as expressed in § 4 as to refund obligations, and in § 5 as to the prohibition of undue preferences. This is not to say that wherever a potential refund liability exists, that it is mandatory upon the Commission to order payment.[92] At the minimum, however, we would require the Commission "to look at the backdrop of the practical consequences" of its refund order, *F.P.C.* v. *Tennessee Gas Transmission Co.*, 371 U.S. 145, 155 (1962), and to assess in a diligent manner whether effects prohibited by § 5(a) exist, and if so, whether they are avoidable. As in the case of the contingent escalation, we do not think that the supply shortage or need for capital rationale have been responsive to the asserted problems of discrimination and anti-competitive effects, and this must be cured on remand.[93]

In *Placid Oil Co., supra,* the Fifth Circuit stated that the "FPC realized that its refund credit program would not benefit all producers equally" and approved that result and added that the FPC had discretion to provide an incentive through the "work-off" provision. Slip op. at 51-53, *accord, Other Southwest Area Rate Case, supra,* slip op. at 28-29. We can agree with both of those propositions, but feel that the substantial potential for anti-competitive effects and discrimination require a response to the contentions of the petitioners.

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[92] Continental Oil Co., *supra,* at 522.

[93] Mesa Petroleum, *supra* at 192.

C. *Effect of Order 455*

Our remand for further consideration will permit the FPC to take into account the implications of Order 455, implementing an "Optional Procedure for Certificating New Producer Sales of Natural Gas," which allows producers to opt out of area rate prices and regulation for "gas produced from a well or wells commenced after April 6, 1972" or for "gas not previously sold in interstate commerce,"[94] and instead negotiate prices with buyers.

The interphase of these two systems should be examined by the Commission. We indicate no view as to whether, or to what extent, the availability of the "de-regulated" system is valid or will obviate the potential defects of the Commission's area-rate system in its present form.

VIII. CONCLUSION AND DISPOSITION

We find ourselves, at the end of the opinion, poised for the announcement of our order, yet uneasy that we have failed to identify and come to grips with a critical aspect of the case. We refer to the regulatory climate and context. Much of the learning on natural gas regulation, learning in both the Commission's orders and past court opinions, has focused on the public interest, and the interest of the consuming public, in avoiding exorbitant rates. Now there is focus on the public interest in obtaining needed gas supply, and properly so. So long, however, as this is in a context of regulation, and not decontrol, it must be accompanied by reasoned consideration, and coming to grips with issues. It is not in the public interest to lend the forms and trappings of the administrative process (in-

[94] Order 455 at 27 (mimeograph). Also on the horizon, if deregulation does not occur, or as an alternative, is the possibility of uniform rates for the nation as a whole, *see* Notice of Proposed Rulemaking (April 11, 1973), Docket No. 389B, 38 Fed. Reg. 10014 (April 23, 1973).

cluding the element of judicial review) to what is in substance an abdication to the producers. "It is the genius of our system that instead of government ownership we retain the spark of private profit and the drive of private enterprise, maintained under government surveillance at critical pressure points of regulatory policy." [95]

If public control is to avoid mere abdication, it must continue to require reasoned analysis, to assure fidelity to the functions assigned to the regulatory agency by the Congress. Judicial review is part of the means of assuring that fidelity.

To some extent, the function of meaningful judicial review is undercut by the tandem regulatory programs that have emanated from the Commission. Thus Order No. 455, for optional deregulation, seems to undercut the premise of area rate regulation, in substantial measure. We do not take the Commission to task for devising new remedies when the situation is in flux, and emergent. We only confess to an uneasiness, that we may be sweeping the snows of yesteryear, while the pertinent climate has changed. We have no option but to perform our assigned task. For that, we think it right to turn again to *Permian,* and to Justice Harlan's statement, 390 U.S. at 792, that—

> Judicial review of the Commission's orders will . . . function accurately and efficaciously only if the Commission indicates fully and carefully the methods by which, and the purposes for which, it has chosen to act, as well as the consequences of its orders for the character and future development of the industry.

Although the Commission has attempted by its order in

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[95] Lorain Journal Co. v. FCC, 122 U.S.App.D.C. 127, 133, 351 F.2d 824, 830 (1965). Whether present conditions of supply shortage require a new statutory framework, *see* S. Breyer and P. MacAvoy, *The Natural Gas Shortage and the Regulation of National Gas Producers,* 86 HARV. L. REV. 941 (1973), is a concern for Congress.

this proceeding to increase the supply of natural gas, it has not been responsive to petitioners' challenges to the incentive provisions of its rate order, and our judicial review function is thereby hampered.

In Placid Oil Co. v. F.P.C., the Fifth Circuit in approving a rate order, similar to the one we review here, that was the result of a settlement proposal, stated that the "'experiment' rationale of *Permian* and *SoLa I* still warrant a kid glove review of FPC rate cases" though the "kid glove [was not] to hold a rubber stamp". Slip Op. at 10, 11. *But see Other Southwest Area Rate Case, supra,* suggesting, but not requiring, Commission reconsideration of its Order. In *Placid* the contingent escalations on flowing gas provision of the Commission Order were sustained on the basis of extra earnings needed to increase supply. Slip. op. at 33-36. Similar justifications were used to sustain the refund "work-off" provision. We fail, however, to discern a difference between a "kid glove" and a "rubber stamp" if all that is needed as a reason for Commission action is to point to a supply shortage. Even an "experiment" needs a rational design. The Natural Gas Act charges the Commission with protecting the interests of the consumer. We can agree that it is in the consumer's interest to increase the supply of natural gas—but the question with the incentive provisions is whether the supply will indeed be increased, and if so whether this must be at the expense of anti-competitive effects and discrimination on the industry. Unless the Commission is to withdraw from regulating responsibility, it must be responsive to these concerns, which were presented to it by petitioners.[96]

[96] Our remand to the FPC to reconsider the incentive provisions in light of Part VII of our opinion, will require that the agency's record and reasons be supplemented on points relevant to the incentives, if the Commission decides to retain them, and on the inter-relationship with the effects of Order 455.

APPENDIX

This Appendix describes how in arriving at the price for "new" and "flowing" gas, the FPC took into account supply considerations.

"New Gas" Methodology

As a guide to our discussion of "new gas" methodology, we reproduce the Commission's composite cost figures.[1]

Cost of new gas-well gas

Cost elements	Examiner's conclusion [a]	Variable cost range [b]
DD&A:		
Successful well costs	2.77	2.70 to 4.10 cents.
Lease acquisitions	1.13	1.13 to 2.03 cents.
Other production facilities	.34	0.33 to 0.73 cent.
E&D:		
Dry holes	1.44	1.64 to 1.97 cents.
Other exploration costs	1.70	1.29 to 2.18 cents.
Adjustment for exploration in excess of production	1.16	
Production operating expense	2.70	3.11 cents.
Return on production investment	4.90	6.24 to 10.29 cents.
Return on working capital	.35	0.47 to 0.72 cent.
Net liquid credit	(3.50)	(4.10) to (4.41) cents.
Regulatory expense	.14	0.14 cent.
Royalty	2.30	Derivative.[c]
Production tax	.90	Derivative.[c]
Total	16.42	

[a] Based on data from an earlier period.

[b] See 701, 715 [of 45 FPC] for discussion of ranges for the separate components.

[c] While any individual cost component might fall within the

[1] 45 FPC at 704.

range indicated for it, it is improbable that either the high or low limit of every range would properly be cumulated to produce a total equal to the highest or lowest range of cost, so no total range may be derived upon which royalty or production taxes might be computed. Both royalty and production taxes are percentages of the total price of the gas.

NOTE.—To these costs must be added 0.4 cent for gathering and delivery.

An examination of the derivation of both the costs and ranges of cost reveal that the Commission was responsive to increasing costs and the need to increase supply.

The first important point about the Commission's approach is the use of the variable cost range. The proposed initial decision of the Examiner was issued on September 16, 1968,[2] and the Commission decision on May 6, 1971. With the passage of time more data developed as to the possible trends in increased costs. In part, therefore, the variable cost range represents an update of data, or a possible range of costs which these data would support.

The calculation of "Successful Well Costs" may serve as an example.[3] As the FPC explained, the computational method used since *Permian* is to divide drilling costs per foot by gas reserves added. As to the numerator, drilling cost per foot, the Examiner used the data of U.S. Census Bureau's Census of Mineral Industries, taking the $16.48 figure from the 1963 Census, the last available census. The FPC departed from this finding in two ways. First, it used the 1967 Census Figure (published subsequent to the Examiner's decision) of $22.22. Second, it used the Census data only as a starting point, and then "trended" the Cen-

[2] The decision of Examiner Taylor is reported at 45 FPC 758 (1971).

[3] 45 FPC at 693-695 (Commission); 45 FPC at 780-82 (Examiner).

sus figure on the basis of the Joint Association Survey (JAS) data, from industry sources, which predicted gradually increasing costs by a certain factor, as of 1969, arriving at a figure of $24.66. This FPC approach thus (a) provided an update of information, through use of the 1967 Census Figure, and also (b) a change in methodology through use of JAS data to "trend" the last available Census Figure.[4]

Similar departures occurred as to the calculation of the "productivity" denominator of the fraction, *i.e.*, gas-well reserves added per foot (Mcf). Thus the Examiner, on the basis of the AGA-API Reserves Committee report, took an average of productivity for the years 1947-1965, arriving at the figure of 596. The Commission on the other hand, for the purposes of calculating a range, took three different averages: 1964-68 (723); 1964-69 (654) and 1947-69 (602). Again the FPC used updated information. And again the FPC made a change in methodology by its use of shorter averaging periods, which the Examiner had rejected as less reliable.[5]

This combination of changes resulted in an FPC calculation of upper ceiling a variable cost range of "Successful Well Costs" with an upper ceiling of 4.10 cents per Mcf as compared with the Examiner's finding of 2.77. A similar pattern obtains for other costs. In calculating ranges by alternative methods, the Commission never indicated a preference, but used the range to show that equally valid assumptions, put together with new data, could lead to a wide range of permissible costs for the different estimated items.

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[4] The approach of the Examiner did not altogether ignore the problem of deriving current cost estimates, since he found that the 1963 Census figure for drilling costs approximated the average for the 1958-1965 period. 45 FPC at 781.

[5] *See* 45 FPC at 782.

The calculation of the permissible rate of return on production investment also throws some light on the Commission's methodology in arriving at a cost-based price.[6] The Examiner used the approach of *Permian*. The computation consisted of taking production investment as consisting of successful well costs, lease acquisitions and other production facilities, calculated to be 4.24 cents per Mcf. This investment was to be recouped over an average period of ten years, beginning an average period of one year after investment. This was the "theoretical average rate base." This figure was multiplied by the rate of return, based on a comparable earnings standard, of 10.5 per cent. Thus, the Examiner concluded that the cost element attributable to rate of return on production investment was $4.24 \times 11 \times 10.5 = 4.90$ (cents per Mcf).[7]

The Commission, after raising various questions about methodological difficulties in calculating a rate of return, stated that "[i]n light of the current higher costs of capital and the need for additional incentives for investment in gas exploration" that the rate of return adopted would be 15 percent. Evidently assuming that recoupment of investment occurred over a shorter than 10 year period, or that a one year time lag was insufficient, the Commission applied the 15% rate of return to a "theoretical average rate base" calculated by multiplying production investment

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[6] 45 FPC at 697-99 (Commission), 801-835 (Examiner).

[7] Neither the Commission nor Examiner adopted an alternative basis for calculating rate of return, the DCF (discounted cash flow) project accounting method, urged by producers. DCF discounts cash outflows and inflows to the present, to equate the present value of investments and benefits. The Examiner believed that the book value method adopted was "wholly compatible with those achieved by application of the more complex, though no more reliable, DCF project method." 45 FPC at 808.

cost by a factor of 10, rather than 11. Given the range of production investment from 4.24 to 6.86, this produced a variable range for rate of return of 6.24 ($4.24 \times 10 \times 15$) to 10.29 ($6.86 \times 10 \times 15$) cents per Mcf.[8]

Having calculated a variable range of costs, the Commission selected the 24 cents price as that which would be used for new gas-well gas. In support of this price, the Commission made two points: (1) non-cost factors were not quantified separately, but were instead reflected in each cost item, and (2) the price was within a range of possible prices, 22-26 cents per mcf, which the variable cost ranges would support.

By non-cost factors, the Commission meant "such considerations as the incentive necessary to elicit additional supplies of natural gas, competitive consequences upon the industry, and the need for adequate capital to finance further exploration and development."[9] Presumably, this inclusion of non-cost factors was reflected in raising rate of return from 10.5% to 15%. The approach to reflect non-cost considerations in each cost component, rather than in a separate category, was a departure from the Examiner's approach and from the *Permian* methodology generally.

The Examiner described the approach used since *Permian* as follows:[10]

> In Opinion No. 468 [*Permian*] the Commission stressed the importance of encouraging a level of exploratory effort which would continue to provide for

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[8] The derivation of the 4.24 and 6.86 figures are from the sum of the Examiner's costs for production investment (Successful Well Costs + Lease Acquisitions + Other Production facilities) and the sum of the high side of the variable range of the Commission's costs for production investment.

[9] 45 FPC at 705.

[10] 45 FPC at 793-94.

> findings (reserves added) in excess of production. It concluded that since revenues are obtained only from production, the "total cost of finding the necessary volumes of gas must be translated into an allowance per Mcf of gas produced so as to bring in the necessary revenues." To this end, a 37 percent conversion factor was developed to adjust the per Mcf cost of unsuccessful E and D [Exploration and Development] efforts from the volume of gas produced during the year.

Following this procedure, the Examiner took various finding/production ratios, and determined that the evidence indicated a 37 percent figure, the same as utilized in *Permian.* The Examiner had calculated E & D at 3.14 cents (sum of cost of Dry holes and of other exploration costs), and applied the adjustment factor of 37%, for exploration in excess of production, to yield an additional 1.16 cents per Mcf.[11]

The approach of the Examiner was intended to keep the findings/production ratio at its past level, which he calculated was close to 139% for the four year average of 1963-1966. As we have already noted, however, the F/P ratio has been below unity since 1967. In the view that a continuation past policy would prove inadequate to cure supply shortage, the FPC made adjustments to individual cost figures.

The FPC explained its choice of a maximum price, of 24 cents, as follows: [12]

> We can state with certainty that the facts before us in these proceedings support the result we have reached. It could also support a price higher or lower by as much as two or more cents in either direction; in other words, we could, with ample support select individual cost components to yield a result within this range, or an even larger one.

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[11] *See* Table at p. 73 *supra.*

[12] 45 FPC at 705.

The Commission went on to state:[13]

> Our finding that 24 cents per Mcf is the just and reasonable rate for new gas is within the range or zone of reasonableness, which we find to exist and our selection of this price represents our judgment as to the level necessary to elicit additional supplies from this area. . . . We find that 24 cents is consistent with nationwide costs of new gas, and calculated to permit the interstate market to make some inroads into the trend of gas sales to seek the intrastate market in the Texas Gulf and other competitive market areas, nationwide.

The table set out at the beginning of this Methodology discussion reveals that it did not include cost figures for royalties or production tax, even though these costs were determined by the Examiner, calculated as percentages of the total cost of new gas-well gas; 4% for royalties and 7% for production tax. The reason for this non-calculation has more to do with the use that is to be made of the variable cost range than it does with the difficulties of calculation. Thus, the Commission states:[14]

> While any individual cost component might fall within the range indicated for it, it is *improbable* that either the high or low limit of every range would properly be cumulated to produce a total equal to the highest or lowest range of cost, so no total range may be derived upon which royalty or production might be computed.

Leaving aside this warning, it is, nonetheless, instructive to calculate the range of total cost which would result from cumulating the lowest costs and the highest costs, in the range of costs for each item. A mathematical calculation, on this basis, shows a resulting range of total costs from a low of 16.19 cents to a high range of 26.08

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[13] *Id.*

[14] *See* footnote c, Table at p. 73, *supra.*

cents.[15] Our calculation confirms the Commission's indication that 26 cents would be the highest price its data would support, a price reached only on the "improbable" assumption of cumulating the higher limit in the variable range of costs for each item.

Viewed in this light, the 24 cents price is seen to lie between 16 cents and 26 cents (with appropriate adjustment), and thus is within the range. The selection of a specific figure tilted toward the high side of the cumulative range was presumably dictated by supply considerations. It will be recalled that these same supply considerations accounted for the higher limit for each variable range item.

That the 24 cent FPC price was based largely on supply considerations is also confirmed by the Commission's comparison of the 24 cents price chosen with the price currently paid for gas in the intrastate market, a demand which competes with that of the interstate market. The FPC obtained a compilation of contract prices recorded in the intrastate market since 1966. These data indicated a low price of 10.025 units per Mcf, for a contract entered into in 1967, and a high price of 24.38 cents, for a contract dated in 1970.[16] Although the Commission indicated that it expected intrastate prices to go even higher, and there is already information to support this view, it is clear that the Commission chose a price which it thought would give the interstate market a fair chance of competing with the intrastate market. As the Commission

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[15] There is no direct translation from cost determinations to ceiling price. In the proceeding before the Examiner, his 16.42 cents per Mcf cost figure was adjusted to reflect certain additional costs associated with bringing gas up to pipeline quality. The Examiner, therefore, recommended a price of 17.4 cents for ungathered gas and 17.8 cents for gathered gas. 45 FPC at 867.

[16] 45 FPC at 706.

stated, "no substantial amount of gas will be obtained for interstate pipelines unless interstate buyers can offer prices competitive with the dominant intrastate market." [17]

"Flowing Gas"

The 24 cent rate thus reached was made applicable by the FPC only to "new gas." Under the three-vintage system prescribed by its Order, the October 1, 1968 cut-off date for new gas made that price applicable only to gas sold under contracts dated on or after October 1, 1968. The Commission also established prices for two vintages of "flowing gas": for gas sold under contracts dated prior to January 1, 1961, and for gas sold under contracts dated on or after January 1, 1961, and prior to October 1, 1968. We now discuss the Commission's approach to pricing these vintages of gas. We defer discussion of the justification for the cut-off between new and flowing gas; here we consider only the method employed to set the price for "flowing gas," a price that some producers challenge as too low, and not justified on the record.

As to "flowing gas," the Examiner's approach, which followed the methodology of *Permian,* was to base price strictly on costs, with little consideration given to non-cost factors, such as the need for increased supply. In his view any incentives for additional exploration activity were to come through the price of new gas.[18] There seem to be two reasons for his approach: (1) prices above cost could not function as a reward for past exploratory activity, because prior to 1961 there was little "directionality" in the exploration for gas, *i.e.,* one only explored for oil, and (2) prices above cost would naturally be unrelated to new discovery because the gas in question was already discovered, and, thus, any increase of the flowing gas rate would merely

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[17] *Id.*

[18] 45 FPC at 865-868.

be a windfall for producers. The producers argued for a single priced system based on current costs, which they claimed was required "because revenues for current explorations and development must be internally generated from sales of gas from whatever source," [19] and because new discovery could not take place only as a function of the new gas price, since funds for investment purposes had to be generated from flowing gas revenues. Rejecting this producer approach, the Examiner considered this source-of-funds contention insubstantial, as distinguished from the issue of inducement, and was concerned lest the order provide funds, for the purpose of enhancing discovery, which would effect a windfall if not directed to new discovery, and made applicable to "flowing gas."

In setting a flowing gas rate, the Examiner calculated historical costs, in a manner similar to that used in calculating current costs for the new gas price. The composite cost figures produced by this approach were: [20]

	Cents/mcf.
(1) Unit production cost	7.38
(2) Additional Allowances to bring gas up to pipeline quality	
(a) Separate gathering	.13
(b) Producer Plant Costs	.81
(c) Pipeline Incurred Cost	.14
(3) E&D expense	4.10
(4) Regulatory expense	.16
(5) Production Tax	.93
	13.65

Unit production costs were broken down as follows: [21]

Cash operating expense	2.03
DD&A	2.13
Return Allowance	3.22
	7.38¢

[19] 45 FPC at 780.

[20] 45 FPC at 873.

[21] 45 FPC at 857.

The return allowance of 3.22¢ reflected use of a 10.5% rate of return, the same as the rate of return allowed on new gas. The Examiner, on the basis of these cost items, found that 13.7 cents per Mcf would be the "just and reasonable" ceiling rate, to govern contracts negotiated before January 1, 1961, the cut-off date he set for flowing and new gas.

The principal impact of the "flowing gas" rates is the effect upon outstanding refund obligations. Prior to the proceeding, the FPC had, through a certification procedure, authorized new deliveries on contracts with prices set, on the basis of a market price, subject, however, to a Commission determination of the "just and reasonable rate," the right to sell at a negotiated price being thus conditioned on refund obligations. *See* Atlantic Rfg. Co. v. Pub. Serv. Comm'n (CATCO), 360 U.S. 378 (1959). Since the area rate "retroactively" establishes what was a "just and reasonable rate," it simultaneously determines what portion of a price charged in the past must be refunded.

The Commission changed the Examiner's approach in several respects: The Commission provided that there would be two, instead of one, vintages of flowing gas, and that the price for each vintage would increase over time and be keyed to the date of delivery. The Commission also departed from the Examiner in calculating the base price upon which the escalations were to be based.

In deciding to create two vintages of flowing gas, the Commission indicated it was following the approach the Commission took in the Southern Louisiana Area Rate Proceeding, 40 FPC 530 (1968).[22] The choice of two vintages would seem to be related to differences in historical costs and the passage of time between the Examiner's and Commissioner's decision: thus, the pre-1961 period was dealt

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[22] *See* text of opinion at note 5, *supra.*

with by the Examiner as a flowing gas rate and the 1961-1968 period was dealt with as new gas, which by the time the Commission issued its decision, had, in fact, become flowing gas.

The Commission stated that it would take as a starting point the prices recommended by the Examiner for these two periods, the 13.68¢ price for pre-1961 gas, and an 18 cent price for the 1961-68 period (the Examiner's price for the second period, which he had calculated as being new gas, was 17.4-17.8 cents per Mcf). It then proceeded to adjust both prices.

For pre-1961 gas, the Commission raised the base rate to 15 cents, "[i]n order to assure that inaccuracy shall not result in the producers receiving less than their cost, including a proper rate of return. . . ."[23] The Commission then outlined a means by which this 15 cent "base price" would be increased depending on the date of delivery: 15 cents for gas delivered prior to January 1, 1965, at least a 17 cent ceiling for gas delivered after January 1, 1965; except that a 19 cent price applies to gas delivered after January 1, 1968. Four justifications were given for this escalation provision: (1) well drilling costs have increased between 1961 and 1968; (2) well rehabilitation and equipment repair and replacement is more of a factor in the Texas Gulf Coast than in any other major area; (3) a large percentage of 1962 flowing gas in the area comes from very old, low-cost leases, and as the amount of this low-cost gas declined, the average cost of 1962 flowing gas would increase in later years; and (4) "we recognize the importance of revenues from flowing gas a source of funds for new investments by the producers."[24]

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[23] 45 FPC at 707.

[24] 45 FPC at 707.

Since the first three factors were all available to the Examiner,[25] it seems likely that the last factor, supplying increased capital, is the likely explanation for the Commission action, especially in light of additional yields given on "flowing gas" by the contingent escalation feature of the rate order.

For gas sold under contracts dated between January 1, 1961, and October 1, 1968, the escalation features were similar. The increase in base and escalated prices was justified largely by reference to cost increases over time not considered by the Examiner because of the timing of his decision (1968).[26] The need for increased capital may again be used to justify the elevation of the Examiner's price.

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[25] *See generally* 45 FPC at 842-865 (Examiner's discussion of flowing gas costs).

[26] 45 FPC at 708.

BAZELON, *Chief Judge,* with whom RICHEY, *District Judge,* concurs: At the heart of this case lies the problem of ensuring an adequate, continuing supply of natural gas to consumers in the interstate market. We are told that the nation is suffering a shortage in its gas reserves that has already reached crisis proportions and that threatens to become increasingly severe. In both major parts of its order in this proceeding—the system of incentives and the schedule of base area rates—the Federal Power Commission has responded to this supply shortage problem. The Commission justifies the incentive features[1] solely on the ground that they are necessary to elicit increased gas supplies, without regard to the producers' cost of service. We agree with Judge Leventhal that these non-cost incentive provisions must be remanded to the Commission for further consideration.[2] But our reasons for doing so lead us to reject the base area rate schedule as well. The defect that we find in the Commission's order is, essentially, a lack of information, a lack so pervasive that, even within the narrow limits of our judicial review function, we are unable to say whether the rates announced in this order are reasonable or whether they comport with the requirements of the Natural Gas Act.

I

As Judge Leventhal points out, the base area rates devised by the Commission for both new and flowing

[1] These include provisions allowing credits on existing refund obligations and contingent escalations in the rates applied to flowing gas. *See* Opinion of Judge Leventhal, *supra,* at 47ff.

[2] The defects that Judge Leventhal rightly finds in those portions of the Commission's order dealing with the system of incentives include both the lack of adequate justification relating the incentives to the objective of increased supply and the discrimination among producers and consumers that the incentives involve.

natural gas contain significant upward adjustments purportedly justified by the supply shortage factor. In selecting the 24 cents price for new gas-well gas, the problem of supply entered the calculus at two points. First, the Commission took non-cost factors into account in calculating the components of the variable range of costs (including, presumably, the fifteen percent rate of return) within which the new price was to fall. The non-cost factors were, the Commission said, "such considerations as the incentive necessary to elicit additional supplies of natural gas, competitive consequences upon the industry, and the need for adequate capital to finance further exploration and development."[3] Second, and again apparently because of the supply problem, the Commission chose the 24 cents rate from the high end of the variable range thus calculated.[4] As to the flowing gas rates, the Commission adjusted the vintages in light of the passage of time; it then raised the rates applicable to each on the basis of four factors, the last of which—"the importance of revenues from

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[3] 45 F.P.C. 674, 705 (May 6, 1971); *see* Appendix, *supra*, at 77.

[4] Appendix, *supra*, at 80. The Commission concluded:

> Our finding that 24 cents per Mcf is the just and reasonable rate for new gas is within the range or zone of reasonableness which we find to exist and our selection of this price represents our judgment as to the level necessary to elicit additional supplies from this area. We have taken into account the relationship of other pricing areas, because in setting rates for the future, we cannot limit our consideration to one area, and ignore the nationwide situation. We find that 24 cents is consistent with nationwide costs of new gas, and calculated to permit the interstate market to make some inroads into the trend of gas sales to seek the intrastate market in the Texas Gulf and other competitive market areas, nationwide.

45 F.P.C. at 705.

flowing gas as a source of funds for new investments by the producers" [5]—responds to the supply problem.[6]

The Commission has thus presented a wide spectrum of possible results, and argues that any result within that spectrum is, in significant part, cost justified and, *pro tanto,* can be supported by substantial evidence in the record taken in its entirety. The Commission argues, furthermore, that the supply shortage problem that figures so prominently in its results is itself established by substantial evidence. But these arguments cannot conclude our task, even if we undertake an independent examination of their validity. There remains a basic question: the relationship between the supply shortage problem, on the one hand, and the Commission's response, on the other.

The producers have contended, both in their petitions to the Commission for rehearing and in their petitions for review in this court, that the order's base area rates are too low to meet the supply problem that the Commission has identified. We do not follow their contention to the point of holding, or even implying, that because of the supply problem, cost of service calculations should be abandoned altogether as premises for establishing base area rates. On the contrary, we agree with much of what Judge Leventhal has said about the continued usefulness of costs as, at least, threshold criteria for judging whether rates are reasonable.[7] Moreover, we fully recognize that we are required to approve the Commission's rates if they

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[5] 45 F.P.C. at 707.

[6] Appendix, *supra,* at 84-85.

[7] *See* City of Chicago v. FPC, 147 U.S.App.D.C. 312, 458 F.2d 731, 750-52 (1971); City of Detroit v. FPC, 97 U.S.App. D.C. 260, 230 F.2d 810 (1955), *cert. denied,* 352 U.S. 829 (1956).

fall within a "zone of reasonableness."[8] Our disagreement with the Commission (and apparently with Judge Leventhal[9]) concerns, instead, its rather facile identification of

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[8] Permian Basin Area Rate Cases, 390 U.S. 747, 767 (1968); FPC v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944); FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 585 (1942). *See* text and notes at notes 28-33, 44-45 *infra*.

[9] Judge Leventhal declines to reach the adequacy of the Commission's reasons in support of the upward adjustments in the base area rates on the ground that no such objection was presented in the applications for rehearing submitted to the Commission. Natural Gas Act § 19(b), 15 U.S.C. § 717r(b). We cannot agree. The problem we deal with here was specifically raised, as to both the base area rates and the system of incentives, by both the Public Service Commission of the State of New York and by the producers. Referring to the requirements established by the Fifth Circuit in *Southern Louisiana I* (*see* text and notes at notes 55-56 *infra*), the Public Service Commission objected that:

> The Commission here has sought to discharge its responsibility by a few conclusory statements to the effect that it doesn't know what supply will be elicited at this price but believes that there will not be any enhancement of supplies with a lesser allowance (mimeo. p. 33). The Commission's discussion is totally inadequate, failing to explain how it arrived at its conclusion. Sympathetic though we are to the difficult responsibilities placed upon the Commission by the Fifth Circuit's decision, the Commission cannot simply allow that a problem is complex and then ignore it. Of course, definite figures could not be given, but estimates giving the Commission's best judgment of what it believes will be the result of its orders must be given and explained.

Petition for Rehearing of the New York State Public Service Comm'n, Joint Appendix at 821. It is true, of course, that the Public Service Commission had satisfied itself, on the basis of its independent analysis of the problem, that the 24 cents rate for new gas-well gas is not too high; therefore, despite its objection to the Commission's methodology and the lack of reasons for the Commission's conclusions, the Public

the zone of reasonableness with the variable range of costs it has calculated, and its assumption that the zone encompasses the upward adjustments it has chosen to make.

Service Commission has not contested the base rate portion of the order in its petition to this court.

There can be no question, however, that the issue of the reasonableness of the base rates is before us in this case: a number of the producers have challenged the overall adequacy of the rates to meet the supply problem. *E.g.*, Application of Humble Oil Co. *et al.* for Rehearing, Joint Appendix at 675-79. And a substratum of this challenge is that the Commission has failed to make a sufficient "assessment of the consequences of [its] order upon the industry and, most importanly, the industry's probable conduct and performance as a result of the order . . . ." *Id.* at 679-80. Moreover, in its separate application, one of the producers raised the precise question that concerns us here:

> In summary, it is apparent that the Commission has failed to explain the relationship between level of service, the demand for service and the price established. A reviewing court cannot satisfy itself from the Commission's opinion that the "end-result" test has been met.

Application of Mobil Oil Co. for Rehearing, Joint Appendix at 770.

We are confronted here with the producers' contention that, even within the variable range of costs, the Commission's choice of rate is too low, and that the upward adjustments it has made are unreasonable responses to the supply problem. We by no means conclude that the producers' contention is correct. We do conclude, however, that in order to deal with the challenge to the Commission's order in a responsible way, we must be supplied with the Commission's reasons for doing what it has done. The purpose of § 19(b)'s "urged . . . in the application for rehearing" requirement is to ensure that the Commission has been afforded the opportunity to consider objections to its orders and to make whatever corrections it deems necessary before these objections are urged to the reviewing court—thus preserving the Commission's primary jurisdiction. *See* City of Pittsburgh v. FPC, 99 U.S.App.D.C. 113, 237 F.2d 741, 749 (1956). We

In the *Permian Basin Area Rate Cases*,[10] the Supreme Court imposed on reviewing courts an obligation to "require criteria more discriminating than justice and arbitrariness" in appraising the Commission's orders. Although it is neither our function nor within our capacity to substitute our own judgment for that of the Commission, we must assure ourselves that the Commission has "given reasoned consideration to each of the pertinent factors." To this end the Commission must indicate "fully and carefully the methods by which, and the purposes for which, it has chosen to act, as well as its assessment of the consequences of its orders for the character and future development of the industry." We are responsible, not for determining what the Commission might have done in this proceeding, but for judging, on the basis of the record and the Commission's reasoning, what it has done, and whether "each of the order's essential elements is supported by substantial evidence."[11]

As we shall set forth, the problem of supply has come to play an increasingly central role in the Commission's efforts at rate regulation under the Natural Gas Act. The order before us in this case represents one more step—a substantial step—in this process. The fact of the matter is that the Commission has used cost of service calculations, in the traditional regulatory sense, only as starting points in fixing the rates contained in its order; the range

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think that the Commission has been afforded this opportunity here. Furthermore, we think it necessary to recognize that the system of incentives and the schedule of base area rates are, as a practical matter, inextricably intertwined. The public interest can only be furthered by remanding both parts of the order to the Commission for reconsideration and for a reasonable explanation of their relationship to the supply problem and to each other.

[10] 390 U.S. 747 (1968).

[11] *Id.* at 790-92.

of variable costs is infused throughout with non-cost factors. We think the time has come to recognize that these factors are "essential elements" of the Commission's order, and to apply to them the standard of review that the statute mandates.

The Commission's justification for the upward adjustments in the base rates is contained in the following paragraph of its opinion:

> There is no reliable evidence which would indicate the amount of new gas reserves that would be discovered as the result of any specific change in rates, nor evidence as to the amount of such reserves that would be dedicated to the interstate market. However, it is our judgment that the new gas prices we establish herein will result in increased drilling efforts by the producers and new gas discoveries in the Texas Gulf Coast area. We are of the view that increased efforts in the Federal domain [i.e., offshore] area will be successful. The Potential Gas Committee estimates probable reserves of 40 trillion cubic feet in this offshore area. Although we realize the unregulated intrastate market will be successful in contracting for some of these new reserves—to the extent that the reserves are not in the Federal domain—it is our goal to establish a price which will both substantially increase discoveries and permit interstate pipelines to compete with intrastate purchasers for these new reserves.[12]

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[12] 45 F.P.C. at 689. The Commission continued:

> We continue to hope for more precision, but for the purposes of our decision here, we can be no more precise than to say that although we cannot forecast the quantum of new supplies which will be elicited by our pricing determinations, we can state with some certainty that we do not believe that there will be any enhancement of supplies with any lesser allowance than we have decided upon.

Id. at 703. So far as we can tell, however, the Commission nowhere states with any clarity the evidence or the reasoning from which this "certainty" is derived.

The Commission has thus informed us—frankly and with full regard for our responsibilities—that it does not know what "the consequences of its order for the character and future development of the industry" will be. It has informed us that it believes the rate schedule it has decreed will result in increased discovery and dedication of natural gas to the interstate market. On the surface, this conclusion seems obvious; it appears to say only that supply may be influenced by price.[13] The question that the Commission must answer, however, is not whether *some* increases in rates are necessary, but why it believes that *these* increases, in combination with the other elements of its order, are a reasonable response to the problem of supply that it says exists. And its answer to that question is what we must review for substantial evidence and

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[13] The obviousness, however, is somewhat superficial. The Commission itself seems to have recognized that increasing rates will not necessarily increase exploratory efforts and, hence, available supply. Nonetheless, it observed that "[t]he possible truth of this argument does not detract from the fact that failure to increase revenues will predictably result in no increase in exploratory effort." 45 F.P.C. at 703-04. Furthermore, it seems possible, and perhaps likely, that an increase in interstate prices will simply lead to a corresponding increase in the competitive intrastate price—a price that, of course, the Commission is without jurisdiction to regulate. In short, unless there is reason to believe that the rates the Commission has set and the price in the intrastate market will be, at least for some time in the future, in equilibrium, then we can see no reason for supposing that these rates will be adequate to bid supply away from the intrastate market. In fact, they may merely contribute to an upward price spiral, forcing consumers to pay more, while not diminishing the supply problem. *Cf.* Kitch, *The Permian Basin Area Rate Cases and the Regulatory Determination of Price*, 116 U. PA. L. REV. 191, 206-07 (1967). We can see no basis in the Commission's report for concluding that such a reason exists; on the contrary, the Commission has said that the trend of intrastate prices is upward. 45 F.P.C. at 706.

for reasoned justification that takes full account of the interests Congress intended this statute to protect. We find neither such evidence nor such justification in the record here.

It is necessary that we admit, as the Commission has admitted, that it may be impossible for it to discharge its responsibility under this statute, this procedural mechanism, and in this atmosphere of crisis. But if the choice is to maintain the form and suffer the evils of self-deception, or to require that whatever regulation we have be responsibly imposed, we must choose the latter. If the statute will not support the results that the Commission thinks appropriate, then it is the province of Congress to alter the statute.

II

And the statute is, we think, a substantial part of the problem. When the Natural Gas Act was enacted in 1938, granting the Federal Power Commission jurisdiction to regulate the transportation and sale of natural gas for resale in interstate commerce, it was generally thought applicable only to sales by interstate pipelines to intrastate pipelines and distributing companies, and not to initial sales by producers to the pipelines.[14] The legislative history of the Act indicates that several factors combined to cause Congress to confer this jurisdiction. The first was the rapid expansion and increasing importance of the natural gas industry itself.[15] As the industry

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[14] *See* Note, *FPC Regulation of Independent Producers of Natural Gas*, 75 HARV. L. REV. 549 (1962).

[15] Hearing Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, on H.R. 11662 to Regulate the Transportation and Sale of Natural Gas in Interstate Commerce and for Other Purposes, 74th Cong., 1st Sess. 10-12, 48-52 (1936).

developed, ownership of the pipelines came to be concentrated in the hands of a few companies, and state utility commissions, which had regulated intrastate pipeline sales to local distributors, found themselves unable, because of a combination of factors, to regulate the prices of the new interstate giants.[16] Gas in the interstate market was thus subject to monopolistic controls: the interstate pipelines limited supply,[17] prices were openly discriminatory,[18] and attempts were made to drive "raiders"—those who tried to introduce competing pipelines—from the market.[19]

In the face of these problems, the overriding concern of Congress was to move back up the chain of distribution and to control the interstate movement of gas that the

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[16] By 1936, four holding company groups controlled more than 55 percent of the total pipeline mileage in the nation. *Id.* at 12, 49. The use of holding companies to control companies that sold to one another along the chain of distribution placed the states in the position of attempting to determine the reasonableness of prices not reached at arms' length. Attempts to inquire into out-of-state pipeline companies' rates were frustrated first by the obstinance of the companies, *see* Hearings Before the House Comm. on Interstate and Foreign Commerce, on H.R. 4008 to Regulate the Transportation and Sale of Natural Gas in Interstate Commerce and for Other Purposes, 75th Cong., 1st Sess. 93 (1937), 1936 Hearings, *supra*, at 93, 87-89; later by the costs of conducting investigations, 1937 Hearings, *supra*, at 50; and finally by Supreme Court decisions holding that such assertion of regulatory power went beyond the limitations placed on the authority of the states by the Interstate Commerce Clause, *e.g.*, *Peoples Natural Gas Co. v. Public Service Comm'n of Penna.*, 270 U.S. 550 (1926).

[17] 1937 Hearings, *supra*, at 90 ff.

[18] 1937 Hearings, *supra*, at 47, 89-91, 101-03; 1936 Hearings, *supra*, at 17.

[19] 1937 Hearings, *supra*, at 70-73; 1936 Hearings, *supra*, at 62.

states had been unable to reach. Quite naturally, the proposed legislation simply adopted the regulatory approach that had been in use in the states and in other areas of federal regulation, such as railroads.[20] The thought was that if prices established between interstate pipelines and intrastate pipelines and distributing companies were being unfairly inflated, it was only necessary to pierce the holding company veil and to determine, apparently on the traditional regulatory basis of cost of service, the just and reasonable rate for the interstate market. Indeed, supply, to the extent that it was considered at all, was broached only in terms of the need to prevent waste of gas by smoothing out the paths of interstate commerce.[21]

In reciting these aspects of the legislative history, we do not mean to be drawn into the fervent and continuing debate as to whether it supports FPC jurisdiction over independent producers of natural gas.[22] The Supreme Court resolved this question definitively in *Phillips I*.[23] We do mean to indicate, however, that under this statute the problems of regulating the interstate market in natural gas, difficult enough when such regulation extended to interstate pipelines (including those integrated with producers), became even more difficult, perhaps intractably so, when it was extended to cover the entire interstate field market. As the Supreme Court recognized in *Permian*, "[p]roducers of natural gas cannot usefully be classified as public utilities."[24] Yet, whatever the inten-

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[20] *Compare* 49 U.S.C. §§ 1 *et seq.*

[21] *E.g.*, 1937 Hearings, *supra*, at 84-87.

[22] *See, e.g.*, Kitch, *Regulation of the Field Market for Natural Gas by the Federal Power Commission*, 11 J. OF LAW AND ECON. 243, 248-57 (1968); Note, *Legislative History of the Natural Gas Act*, 44 GEO. L. J. 695 (1956).

[23] Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

[24] 390 U.S. at 756.

tion of its framers, the system of regulation and regulatory standards established by the Natural Gas Act, appropriate enough for the pipelines themselves, was, in Justice Harlan's phrase, "ill-suited" to anything other than the regulation of public utilities and of the processors or transporters of otherwise freely priced commodities. In establishing the statutory scheme, Congress simply did not advert to the difficulties that regulating the field price of natural gas would pose, difficulties brought into full relief in the course of the Commission's regulatory attempts.

We rehearse, therefore, the history of judicial review of Commission rate orders under the Act not only to define the legal standards that must guide our decision, but also because this history demonstrates with full clarity the dilemma in which we now find ourselves. The touchstones of review in the Act itself are, as we have noted, derived from traditional regulatory statute formulae. Section 19(b),[25] which authorizes review of Commission rate orders by the courts of appeals, provides that the Commission's findings of fact, "if supported by substantial evidence, shall be conclusive." Section 4(a)[26] requires that the rates of natural gas companies subject to the Act "shall be just and reasonable . . .;" section 5(a)[27] directs the Commission to "determine the just and reasonable rate" to be observed and to "fix the same by order." The terms "just" and "reasonable" are not, of course, self-defining. Since the passage of the Act the courts have attempted to infuse them with some content that would at once preserve the integrity of the judicial review process and, at the same time, free the Commission to confront the peculiar problems of the natural gas market.

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[25] 15 U.S.C. § 717r(b).

[26] 15 U.S.C. § 717c(a).

[27] 15 U.S.C. § 717d(a).

In *FPC* v. *Natural Gas Pipeline Inc.*,[28] the Supreme Court identified the lowest rate permissible under the just and reasonable standard with the lowest rate that may be fixed without being confiscatory in the constitutional sense. The Court observed that there exists a "zone of reasonableness within which the Commission is free to fix a rate varying in amount and higher than a confiscatory rate." Within this zone, the Commission may make 'the pragmatic adjustments which may be called for by particular circumstances."[29] Two years later, in *FPC v. Hope Natural Gas Company*,[30] the Court reiterated the expressions of *Natural Gas Pipeline* and amplified the regulatory discretion allowed. *Hope* established a permissive constitutional approach, the most important consequence of which was to permit the use of original cost, rather than reproduction cost, in computing a rate base.[31] More broadly, however, *Hope* freed regulation from the use of traditional legal accounting methods in arriving at just and reasonable rates: "Under the statutory standard of just and reasonable it is the result reached not the method employed which is controlling . . . . It is not theory but the impact of the rate order which counts."[32] Natural gas ratemaking, the Court said, involves the balancing of investor and consumer interests, and, from the investor side, it is important that there be sufficient revenue to cover both operating and capital costs. To protect this interest, "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."[33]

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[28] 315 U.S. 575 (1942).

[29] *Id.* at 585.

[30] 320 U.S. 591 (1944).

[31] *See* Kitch, *supra* note 13, at 203.

[32] 320 U.S. at 602.

[33] *Id.* at 603.

The criteria that the Court advanced were, perhaps, easy enough to apply in the context of *Hope* itself, which concerned an individual company with an excellent earnings record.[34] But the concerns voiced by Justice Jackson in his separate opinion have increasingly come to the fore. Justice Jackson observed that Hope's business comprised two elements. The first element—the pipeline—was "essentially a transportation enterprise . . . not differing substantially from many other utility operations;" to this element traditional cost of service rate making might appropriately be applied.[35] But the second element of Hope's business—"to reduce to possession an adequate supply of natural gas"—differed radically:

> The heart of this problem is the elusive, exhaustible, and irreplaceable nature of natural gas itself. Given sufficient money, we can produce any desired amount of railroad, bus, or steamship transportation, or communications facilities, or capacity for generation of electric energy, or for the manufacture of gas of a kind. In the service of such utilities one customer has little concern with the amount taken by another, one's waste will not deprive another, a volume of service can be created equal to demand, and today's demands will not exhaust or lessen capacity to serve tomorrow. But the wealth of Midas and the wit of man cannot produce or reproduce a natural gas field.[36]

Because, in Justice Jackson's view, the natural gas market involves a wasting resource, the exploration for and production of which are "more erratic and irregular and unpredictable in relation to investment than any phase of any other utility business," [37] its regulation cannot ultimately rely on the traditional cost-of-service method-

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[34] *See* Kitch, *supra* note 13, at 202.

[35] 320 U.S. at 647.

[36] *Id.* at 629.

[37] *Id.* at 647.

ology. Instead, the central problem of natural gas regulation must involve the functional use of price to elicit a supply of gas adequate to meet demand, and to allocate supply to those uses most efficient and valuable for society:

> The function which an allowance for gas in the field should perform for society . . . is to be enough and no more than enough to induce private enterprise completely and efficiently to utilize gas resources, to acquire for public service any available gas or gas rights and to deliver at a rate and for uses which will be in the future as well as in the present public interest.[38]

The concerns expressed by Justice Jackson have come to pervade the Commission's area rate decisions. When, in 1954, the Supreme Court held that the Federal Power Commission has jurisdiction under the Natural Gas Act to regulate the prices at which independent producers sell gas to interstate pipelines,[39] the Commission at first struggled manfully to regulate individual companies on a cost of service basis. But the attempt proved unsuccessful, both because of the large number of independent producers requiring individual attention and, equally important, because of the conceptual difficulties involved in determining, on an individual basis, the costs of gas production and the appropriate rate of return.[40] In 1960, the Commission decided to abandon the individual cost of service approach and to institute area rate proceedings instead, a decision affirmed by the Supreme Court in *Phillips II*.[41] In setting

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[38] *Id.* at 652-53; *see* Colorado Interstate Gas Co. v. FPC, 324 U.S. 581, 612 (1945) (Jackson, J., concurring).

[39] Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

[40] *See* Permian Basin, 320 U.S. at 756-57; Breyer and MacAvoy, *The Natural Gas Shortage and the Regulation of Natural Gas Producers*, 86 HARV. L. REV. 941, 952-58 (1973).

[41] Wisconsin v. FPC, 373 U.S. 294 (1963).

area rates, the Commission said, "[O]ur ultimate objectives will be to set prices in all producing areas which will be adequate to maintain the gas supplies needed by the consumers of the nation, but at prices that are no higher than are necessary to accomplish that purpose." [42]

To achieve these objectives, the Commission devised a "two-tiered" rate system, a system of which the one before us is a variant. This system involves determining two different prices or sets of prices for each geographically identifiable producing area. The Commission establishes one ceiling price for new gas from gas wells and a second, lower ceiling price for both old, or flowing, gas from gas wells and all gas produced in conjunction with oil. The theory underlying this two-tiered system and its variants is that the market for new gas, because it is still in various stages of development, is responsive to price, while the market for flowing gas and for oil well gas is not.[43] In theory, therefore, the Commission can achieve the best of two worlds: the price for new gas can be set at a level sufficiently high to ensure continued development of new supplies and their dedication to the interstate market, thus preventing shortages, while the lower rates on flowing gas will result in lower prices to the consumer.

In *Permian Basin*, the first area rate case, the Supreme Court gave explicit approval to the Commission's two-tiered system. The Court said that, within a zone of reasonableness, the Commission may "employ price functionally in order to achieve relevant regulatory purposes; it may, in particular, take fully into account the probable consequences of a given price level for future programs of exploration and development." [44] Indeed, the Court indi-

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[42] Phillips Petroleum Co., 24 F.P.C. 537, 547 (1960).

[43] See Kitch, *supra* note 13, at 191-92.

[44] 390 U.S. at 790.

cated that it might well be essential for the Commission to take non-cost factors into account if it is effectively to fulfill its statutory duty to protect the public interest in a supply of natural gas adequate to meet present and future needs.[45]

The Commission had computed the two maximum prices for Permian Basin directly from costs of service; it assumed that the differential between the prices for new and flowing gas resulting from differences in the time periods and geographical areas used to compute costs would serve as a sufficient incentive to production, without introducing noncost factors.[46] Despite its doubts on some points, the Court approved the system of rates that the Commission had established, rejecting challenges to both

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[45] The Court said:

> The Commission cannot confine its inquiries either to the computation of costs of service or to conjectures about the prospective responses of the capital market; it is instead obliged at each step of its regulatory process to assess the requirements of the broad public interests entrusted to its protection by Congress. Accordingly, the "end result" of the Commission's orders must be measured as much by the success with which they protect those interests as by the effectiveness with which they "maintain . . . credit and . . . attract capital."

Id. at 790; and it continued:

> The Commission's responsibilities necessarily oblige it to give continuing attention to values that may be reflected only imperfectly by producers' costs; a regulatory method that excluded as immaterial all but current or projected costs could not properly serve the consumer interests placed under the Commission's protection. We have already considered each of the points at which the Commission has given weight to noncost factors, and have found its judgments consistent with the terms and purposes of its statutory authority.

Id. at 815.

[46] *Id.* at 799-800.

particular elements in the Commission's calculations and to the rate schedule's overall effects. In his opinion for the majority, Justice Harlan defined the responsibilities that a reviewing court must exercise:

> First, it must determine whether the Commission's order, viewed in light of the relevant facts and of the Commission's broad regulatory duties, abused or exceeded its authority. Second, the court must examine the manner in which the Commission has employed the methods of regulation which it has itself selected, and must decide whether each of the order's essential elements is supported by substantial evidence. Third, the court must determine whether the order may reasonably be expected to maintain integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable.[47]

At the same time, the Court fully recognized the "intensely practical difficulties" faced by the Commission in its attempt to regulate the field price of natural gas, and said that the Commission must be given "every reasonable opportunity" to devise regulatory methods appropriate to their solution.[48] Justice Harlan emphasized that the first area rate proceeding was something of an experiment, a fact to which the Court was obliged to give weight in its review of the Commission's order. But he went on to warn that "this weight must materially lessen as the Commission's experience with area regulation lengthens."[49]

It is important, then, that we understand some of the problems that area price regulation confronts, particularly when it is undertaken within the structure created by

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[47] *Id.* at 791-92.

[48] *Id.* at 790.

[49] *Id.* at 792.

Congress in the Natural Gas Act. The rates that the Commission sets for new gas must be sufficiently high to pay the costs of developing new supply sufficient to meet demand, a demand certain to be increased by the lower prices on flowing gas. To do this, the Commission must attempt to determine the marginal cost of future gas production, an attempt that necessarily involves some guesswork.[50] Second, as the Court noted in *Permian*,[51] there is a forceful argument that, in the context of an industry like the development and production of natural gas, calculation of rates on the basis of costs is in any event "hopelessly circular": if, on the basis of predicted costs, the Commission sets the price at a certain amount, the industry will invest resources in new production worth up to that amount but no more; in other words, the Commission's rate per unit of production will elicit costs, including return, equal to it.[52] Third, under the Act, the Commission has jurisdiction to regulate only the prices at which the producers sell in interstate commerce; it has no power to regulate the prices at which the producers sell intrastate within the production region. As a result, to avoid shortage in the interstate market, the Commission must set rates at a level sufficiently high to bid supplies away from intrastate, and primarily industrial, purchasers.[53] Finally, these problems are aggravated by the fact that the Commission must work in an extended time-frame; because of the complexity of area rate proceedings, the Commission must establish a rate structure that it believes will be reasonably efficacious for a substantial period of time.

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[50] *See* Breyer and MacAvoy, *supra* note 40, at 962-63.

[51] 390 U.S. 816 n.99.

[52] *See* Kitch, *supra* note 13, at 195-96.

[53] *See* Breyer and MacAvoy, *supra* note 40, at 960-61.

Because of these considerations, non-cost factors directed to the problem of supply have, since *Permian Basin,* played an increasingly central role, not only in the structure of the area rate systems decreed by the Commission, but also in the calculation of the rates themselves. All of the Commission's subsequent area rate orders have been approved. But we sense in the opinions of our sister circuits at least some degree of uncertainty about the methods that the Commission has employed and the results at which it has arrived. In the first *Southern Louisiana Area Rate Case,*[54] the Fifth Circuit expressed disappointment that the Commission had failed explicitly to explain what effect its rate order could be expected to have on the supply shortage problem. In accordance with the Supreme Court's opinion in *Permian,* the court held that non-cost factors may properly be considered in establishing a rate structure, but that such factors must be clearly labeled and justified on the basis of substantial evidence in the record as a whole. The court concluded that "the Commission here, having calculated the dangers involved in allowing the gas supply to lapse, and the probabilities that its estimates might be too low, is justified in having added the small non-cost factors it thought were necessary."[55] It warned, however, that "use of non-cost factors to allow for possible inaccuracies is not favored. Inaccuracy, if that is *really* the concern (and not higher costs), can result in a windfall to producers as easily as in a loss."[56]

In the second *Southern Louisiana Rate Case,*[57] which

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[54] Austral Oil Co. v. FPC, 428 F.2d 407, rehearing en banc, 444 F.2d 125 (5th Cir.), *cert. denied,* 400 U.S. 950 (1970).

[55] 428 F.2d at 426 n.46.

[56] *Id.*

[57] Placid Oil Co. v. FPC, Slip Opinion No. 71-2761 (5th Cir. April 15, 1973).

involved rates that, in most essential respects, were closely similar those involved here, the Fifth Circuit repeated the concerns it had voiced earlier; but once again it concluded that the Commission's order must be enforced. The Court said that area rate regulation remains an experiment and, therefore, continues to warrant "kid glove review": "No one can honestly say that judges have been any more sure than commissioners as all struggle with a problem that grows out of a peculiar mixture of a simulatoneous service and exhaustion of a depletable asset. All have been groping. The day for groping is not yet over." [58] The Court's decision rested heavily on its recognition that there exists a supply shortage problem—a problem that, the court said, "can only be described as a crisis." [59] The Court concluded that, given this fact, the Commission must "swing the pendulum towards the incentive, supply-eliciting side of rates. And so it has done." [60]

Most recently, in the *Other Southwest Area Rate Case*,[61] the Fifth Circuit observed that, as in *Southern Louisiana II*, the Commission was "unable or unwilling to quantify the relationship between the rates it established and the likely response of market forces." [62] Furthermore, the court recognized that the Commission's upward adjust-

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[58] *Id.* at 11.

[59] *Id.* at 23-24.

[60] *Id.* at 24 n.13. *See also* Hugoton-Anadarko Area Rate Proceeding, California v. FPC, 466 F.2d 974 (9th Cir. 1972).

[61] Shell Oil Co. *et al.* v. FPC, Slip Opinion Nos. 721114, 72-1215, 72-1288, 72-1310, and 72-1541 (5th Cir. June 8, 1973).

[62] *Id.* at 12. Indeed, the Commission had included in its Other Southwest report a statement concerning this relationship that is substantially similar to that which it included in its report in this case. Compare id. at 12 with text at note 8 supra.

ments in rates in response to the supply problem have become significant factors—perhaps, of necessity, *the* significant factors—in the level of rates that the Commission has established. And it said that "[w]e must decide whether FPC has erred in including, excluding, or evaluating components of the rate structure to determine if the particular error washes out in the 'zone of reasonableness,' or has such significance that the result is unacceptable." [63] Yet, despite its doubts on several points, the court felt compelled to enforce the Commission's order.

III

There is no essential disagreement as to the purpose of regulation under the Natural Gas Act. As the Supreme Court said in *Phillips I*, the primary aim of the Act is the "protection of consumers against exploitation at the hands of the natural gas companies . . . ." [64] More broadly put, the purpose of regulation is to ensure that natural gas be distributed at the lowest possible price, that its private producers and distributors not reap windfall profits at the expense of the consuming public, and that allocation of this valuable resource be dictated by the interest of the public, rather than by the interest of its holders in private gain. At the same time, the public interest requires some assurance that, both now and in the future, the supply of natural gas will be sufficient to meet those uses for which, relative to other fuels, it is most valuable.

In most regulatory contexts, perhaps, regulation on a cost of service basis can provide a reasonable approximation of these goals. But, as we hope to have shown, in the context of natural gas regulation, the traditional methodology has simply proved inadequate. By the same token,

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[63] *Id.* at 19.

[64] 347 U.S. at 685.

the fact that rates are "anchored" in costs might once have been enough to ensure that they fall within the zone of reasonableness. But we think this no longer the case. There can be no question that, in this order, non-cost factors—the problem of present and possible shortage—were vital determinants of the rate levels the Commission has set. We fully recognize that the Commission may take such factors into account in performing its statutory duty. But recognizing that this is so cannot solve the problem before us.

The statute imposes on us, as the reviewing court, the responsibility of determining whether the rates the Commission has devised are just and reasonable. And this has come to mean, in effect, whether the Commission has arrived at a reasonable accommodation between protecting the consumer against exploitation in the price he must pay and protecting him against possible shortages in supply. Judge Leventhal accuses us of demanding the platonic ideal in rate regulation, of seeking an unachievable perfection. If insisting on demonstrable rationality is equivalent to demanding perfection, then perhaps his accusation is correct. But we think our goal less exalted. We assume that the Commission had *some* reasons for concluding that its choice from within the variable range of costs and the increment it has added to the rate for flowing gas are preferable to possible alternatives, whether those alternatives are higher or lower. But on the basis of the record before us, we have no way of knowing what these reasons might have been; we have no idea why the Commission thought these upward adjustments adequate to meet the need to encourage exploration and development and to bid supplies away from the intrastate market. Indeed, for all we know they may be more than adequate. We simply do not have, and are not given, sufficient information to make this judgment. We decline to join the Commission in what looks like a flight of faith, even

though it has begun it ascent from the familiar terrain of cost.

The problem in this case is essentially the same as that which I discussed in *International Harvester Company v. Ruckelshaus*.[65] In that case I was convinced that Congress did not intend the courts "to delve into the substance of the mechanical, statistical, and technological disputes" involved in setting automobile exhaust emission standards. Our proper role, instead, was "to see to it that the agency provides 'a framework for principled decision-making.'" Such a framework necessarily includes "the requirement that the agency set forth with clarity the grounds for its rejection of opposing views" and the reasons it has arrived at its results.[66] This principle applies here. Unless the Commission can supply some reasoned justification of the relationship between the causes and dimensions of the supply problem and the magnitude of the adjustments it has made in response to it—adjustments that are by no means *de minimis*—then it is impossible for the parties to confront and challenge the bases for its actions. And it is impossible for us to perform even our narrow review function in any meaningful way.[67] In the absence of such explicit justification, we cannot say with any assurance that the rates decreed in this order are just and reasonable, or that the Commission has reasonably concluded that it is necessary for consumers to bear a substantial increase in the price of this essential fuel. In short, we have no way of knowing what the zone of reasonableness might be.

It may be that the Commission is unable to supply the evidentiary basis and reasoned justification we think the

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[65] Slip Opinion No. 72-1527 (D.C. Cir. Feb. 10, 1973) (Bazelon, C.J., concurring in the result).

[66] *Id.* at 64.

[67] *See* K. C. DAVIS, 2 AD. LAW TREATISE 476-84 (1958).

Act requires, that it has neither the methodological tools necessary for the regulation in which it is engaged nor the means of acquiring the information necessary to their exercise. Indeed, it may be that regulation simply cannot meet the statutory goals set for it. Some commentators have argued that the field market in natural gas is essentially competitive, and that the inefficiencies resulting from regulation greatly exceed whatever beneficial income distribution effects it may have.[68] On the other hand, there are indications that present natural gas reserves are controlled by a small number of companies, and it has been suggested that deregulation would result in enormous windfall profits for a few large producers, while the supply shortage problem would remain at least as serious as it is now.[69] If Congress should decide that neither the present nor some revised scheme of regulation, possibly joined with some form of subsidy for exploration, is capable of protecting the public interest, perhaps deregulation would be appropriate; if it decides that deregulation would result in unacceptable consequences, it might even wish to consider some form of nationalization.

It is, of course, for Congress, not for us, to make this choice and attempt to find a way out of the natural gas crisis. But until it does so, it remains our duty to review

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[68] *See* Breyer and MacAvoy, *supra* note 40; Kitch, *supra* note 22.

[69] Testimony of former FPC Chairman Joseph C. Swidler, reported in the Washington Post, June 27, 1973, at 7, col. 1. *See* Douglas, *The Case for the Consumer of Natural Gas*, 44 GEO. L. J. 566, 589 (1955); "Is the Natural Gas Insdustry Competitive?", N.Y. Times, July 1, 1973, sec. F, at 2, col. 1. We note also recent reports that the reserves of natural gas held by producers may be much larger than had previously been thought. *See* the Washington Post, June 29, 1973, at 1 (describing a Federal Trade Commission Report to a Senate Antitrust Subcommittee).

the actions taken by the Commission under this anachronistic statute. Congress could also, of course, decide to give the Commission, within constitutional limitations, entirely unfettered discretion and to exempt its orders from judicial review. We assume, however, that Congress would not have provided the form of judicial review without intending that review to be conscionably exercised. We can agree with the Fifth Circuit that natural gas regulation is still in the experimental stage. The costs of the experiment, however, are borne by the consumer; he has, at least, a right to some assurance that the experiment is justified. If judicial review is to deserve the name, if it is to be something more than a formal rite of passage that Commission orders must endure merely for the appearance of propriety, then we as the reviewing court must be given the means of divining what experiment it is that the Commission is conducting and why it has chosen to conduct it in the manner that it has. We cannot place our imprimatur on a Commission order, announcing to the public that we find it just and reasonable, when we have no way of knowing that it is.

With respect to the base area rates, this opinion will govern further proceedings under the court's mandate.